No. 87-1097

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

OTIS R. BOWEN, SECRETARY OF HEALTH AND HUMAN SERVICES,
Petitioner,

v.

GEORGETOWN UNIVERSITY HOSPITAL, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR THE RESPONDENTS

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STATEMENT OF THE QUESTION

Whether the Secretary of Health and Human Services may validly apply a retroactive Medicare cost limit rule to recoup from respondents monies that he previously paid them as a result of a final court judgment.

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STATUTES AND REGULATIONS INVOLVED

1. 5 U.S.C. § 551(4)—Appendix ("App.") at 1.
2. 5 U.S.C. § 553(b)-(d)—App. at 1-2.
3. 5 U.S.C. § 706—App. at 2-3.
4. 42 U.S.C. § 1395x(v)(1)(A) (Section 1861(v)(1)(A) of the Social Security Act)—App. at 3-4.
5. Pub. L. No. 92-603, § 223(b) (1972)—App. at 4.
6. 42 C.F.R. § 413.9(b)(1)—App. at 4-5.
7. 42 C.F.R. § 413.30(a), (b)(3)--App. at 5.
8. 42 C.F.R. § 413.64(a)(1), (b), (f)—App. at 5-7.

STATEMENT OF THE CASE

1. In 1965, Congress enacted the Medicare statute (title XVIII of the Social Security Act) to furnish health insurance benefits for the elderly. Pub. L. No. 89-97, § 102(a). The statute required that hospitals furnishing services to Medicare beneficiaries be reimbursed their "reasonable cost." [1] 42 U.S.C. §§ 1395f(b), 1395x(v)(1)(A). It mandated that the Secretary's implementing regulations "take into account both direct and indirect costs" so that non-Medicare patients would not subsidize costs properly attributable to Medicare patients and Medicare would not subsidize costs properly attributable to non-Medicare patients. 42 U.S.C. § 1395x(v)(1)(A)(i); *Northwest Hospital, Inc. v. Hospital Service Corp.*, 687 F.2d 985, 991 (7th Cir. 1982). It also mandated that the Secretary's regulations "provide for the making of suitable retroactive corrective adjustments where, for a provider of services for any fiscal period, the aggregate reimbursement produced by the methods of determining costs proves to be either inadequate or excessive" (42 U.S.C. § 1395x(v)(1)(A)(ii))—referred to by the court of appeals below as the "retroactive corrective adjustments provision" (Petition Appendix ("Pet. App.") at 6a n.5).

The Secretary published implementing regulations a year later. 31 Fed. Reg. 14,808 (1966). The regulations stated that the "reasonable cost" reimbursement standard is "intended to meet . . . actual costs, however widely they may vary from one institution to another . . . subject to a limitation if a particular institution's costs are found to be substantially out of line with other institutions in the same area which are similar in size, scope of services, utilization, and other relevant factors." 20 C.F.R. § 405.451(c)(2) (1966), redesignated 42 C.F.R. § 413.9(c)(2). They construed the retroactive corrective adjustments provision as simply requiring a year-end settling of accounts reflecting the difference between the amount to which a provider is entitled after a full audit of its cost report for a particular year and the amount of estimated payments that it received during that year. *See* 20 C.F.R. § 405.454(f) (1966), redesignated 42 C.F.R. § 413.64(f) (App. at 6-7); 20 C.F.R. § 405.451(b)(1) (1966), redesignated 42 C.F.R. § 413.9(b)(1) (App. at 4-5); 20 C.F.R § 405.454(a)(1), (b) (1966), redesignated 42 C.F.R. § 413.64(a)(1), (b) (App. at 5-6).

[1] This suit applies only to fiscal years subject to cost reimbursement principles. In 1983, Congress enacted a new payment system, generally known as the Prospective Payment System (PPS), which pays most hospitals (including respondents) for inpatient hospital services in accordance with pre-determined rates, irrespective of their actual costs. *See Washington Hospital Center v. Bowen*, 795 F.2d 139 (D.C. Cir. 1986).

Over time, Congress concluded that the original payment standard failed to provide proper incentives for efficiency and economy. H.R. Rep. No. 92-231, 92d Cong., 1st Sess. 82-85 (1971), Joint Appendix ("J.A.") at 52-57; S. Rep. No. 92-1230, 92d Cong., 2d Sess. 187-190 (1972), J.A. at 58-63. It was also concerned that the Secretary's authority to disallow costs was too limited. *Id.* Accordingly, it amended the Medicare statute in 1972 to allow the Secretary to establish prospective cost limits. Pub. L. No. 92-603, § 223(b) (App. at 4).

2. In 1974, the Secretary published a regulation to implement the authority to establish Medicare cost limits conferred on him by section 223(b) of the 1972 amendments. 39 Fed. Reg. 20,164. Consistent with the statutory language and the legislative history, the regulation specified that cost limits "will be imposed prospectively. . . ." 20 C.F.R. § 405.460(a) (1974), redesignated 42 C.F.R. § 413.30(a)(2) (App. at 5). Pursuant to that regulation, the Secretary published in 1974 his first schedule of limits applicable to "routine costs." [2] 39 Fed. Reg. 20,168 (1974). He thereafter published an annual schedule of routine cost limits for the next seven years.

The Secretary's schedules attempted to classify hospitals according to a variety of factors, including "economic environment." The original schedule reflected "economic environment" by establishing five groupings based on "per capita income." 39 Fed. Reg. 20,168 (1974). This generally had the effect of giving hospitals located in areas with high per capita

[2] "Routine services" are generally "bed and board" services; they include "regular room, dietary, and nursing services, and minor medical and surgical supplies." 42 C.F.R. § 413.53(b)(2).

income relatively high cost limits and hospitals located in areas with low per capita income relatively low cost limits. Although the Secretary's annual schedules became more sophisticated with time, the Secretary followed this basic approach to measuring "economic environment" for the next four annual schedules (1975-1978). *See* 40 Fed. Reg. 23,623-23,624 (1975); 41 Fed. Reg. 26,994-26,996 (1976); 42 Fed. Reg. 53,676-53,678 (1977); 43 Fed. Reg. 43,561-43,563 (1978).

In 1979, the Secretary repealed the "per capita income" approach and substituted a wage index system based on data from the Bureau of Labor Statistics ("BLS") to gauge "economic environment." 44 Fed. Reg. 31,807-31,808, 31,812-31,813 (1979). Hospitals in areas with high hospital wages received higher wage indexes, and consequently higher cost limits, than those in areas with low hospital wages.[3] The Secretary retained the wage index approach to measure "economic environment" for the 1980 and 1981 schedules. 45 Fed. Reg. 41,875-41,876 (1980); 46 Fed. Reg. 33,642-33,643 (1981).

3. The Secretary promulgated the first seven schedules of routine cost limits in accordance with the mandatory notice and comment procedures of the Administrative Procedure Act ("APA"). Pet. App. at 49a. However, on June 30, 1981, the Secretary published the eighth, and final, annual schedule of routine cost limits (applicable to cost reporting periods begin-

[3] The basis for geographic comparison used for the wage index was the Standard Metropolitan Statistical Area ("SMSA")—recently renamed Metropolitan Statistical Area—which is a "statistical area" defined by the Office of Management and Budget. 44 Fed. Reg. 31,807 (1979). The wage index for a particular SMSA was determined by dividing the average monthly hospital wage in the SMSA by the national average monthly hospital wage. *Id.* Thus, if the average monthly hospital wage was $1,200 for a particular SMSA and the national average was $1,000, the SMSA's wage index would be 1.2. If the labor component of the Secretary's *per diem* limits was $100, the adjusted labor component for a hospital in that SMSA would be $120 ($100 x 1.2).

ning in the period July 1, 1981 through September 30, 1982) without using APA notice and comment procedures.[4] He explained that "good cause" existed for waiving APA procedures because the 1981 schedule simply used more recent data [5] but was otherwise based on "the same methodology" as the 1980 limits, which limits had been duly issued under APA notice and comment procedures. 46 Fed. Reg. 33,640.

Despite this representation, the Secretary, in fact, changed the methodology for determining the 1981 limits in one very significant respect. The Secretary had previously included the wages of *all* hospitals in determining the wage indexes in his schedules. But in the 1981 schedule, he excluded data from federal government hospitals for the first time.[6] 46 Fed. Reg. 33,639 (col. 1) (1981). He characterized the exclusion as a "minor technical change[ ]." *Id.* at 33,638 (col. 1) (1981).

4. The exclusion of federal government hospital data had a detrimental effect on respondents, all of which participated in suits filed in the U.S. District Court for the District of Columbia to invalidate the new rule. In *District of Columbia Hospital Association v. Heckler,* No. 82-2520 (Apr. 29, 1983) ("*DCHA*") (Pet. App. at 49a-66a), the court (*per* Judge Louis Oberdorfer) declared the new rule invalid because of the Secretary's failure to comply with APA public participation procedures. Pet. App. at 65a-66a. Because the hospitals had

[4] The 1981 schedule of routine cost limits was replaced in 1982 by a schedule of limits applicable to inpatient operating costs. 47 Fed. Reg. 43,296 (1982). In 1983, Congress enacted PPS. Since that time, there have been no Medicare cost limits applicable to hospitals.

[5] The 1980 wage index was based on 1978 BLS data (45 Fed. Reg. 41,868 (1980)); the 1981 schedule on 1979 BLS data (46 Fed. Reg. 33,638 (1981)).

[6] There was no advance warning for this change. Indeed, during the prior year, the Secretary had twice taken action to correct inadvertent omissions of government hospital data from his wage indexes. *See* 45 Fed. Reg. 41,872-41,873 (1980); 46 Fed. Reg. 7,456-7,457 (1981). He gave no hint in those notices that he regarded the inclusion of federal government hospital data as undesirable or that he was considering a change to his wage index methodology.

not yet completed the administrative process under 42 U.S.C. § 1395oo,[7] the court did not expressly enjoin the Secretary from applying the 1981 wage index in settling the hospitals' cost reports. *Id.* at 62a-63a. However, the court refused to grant the Secretary's request to stay invalidation of the wage index rule pending issuance by the Secretary in accordance with notice and comment procedures. *Id.* at 60a-61a. Such relief was appropriate only in cases involving "emergency situations or wholesale disruption of critical government programs, and lack of a prior regulatory scheme to operate in place of the invalid regulations." *Id.* at 61a. Here, however, "invalidation of the 1981 wage index and formula would leave in place the formula that was arrived at after proper notice and comment procedures and was used successfully to reimburse providers prior to July 1981." *Id.*

The court instructed the hospitals to file appropriate claims under 42 U.S.C. § 1395oo. *Id.* at 63a. It noted that "the Secretary and [his] delegates administering the claims procedure . . . are, of course, obligated to follow the law as it is finally interpreted by the Court." *Id.* It also noted that if the hospitals failed to receive the requested relief in the section 1395oo administrative appeals process, they could once again seek judicial relief, this time "armed with . . . [the court's] declaration" of invalidation. *Id.* at 64a. The court stated that "[i]f the Secretary wishes to put in place a valid *prospective* wage index, [he] should begin proper notice and comment procedures. . . ." *Id.* (emphasis added).

The district court reached the same result in *St. Cloud Hospital v. Heckler,* No. 83-0223 (D.D.C. May 2, 1983, as amended May 19, 1983). Both decisions became final on September 1, 1983, when the court of appeals granted the Secretary's motion to dismiss his appeals.

5. Consistent with *DCHA,* the Secretary proceeded to settle respondents' cost reports for the years affected by the 1981 schedule (fiscal years beginning after June 30, 1981, but before October 1, 1982) by computing respondents' routine cost

[7] The § 1395oo administrative process is described in *Bethesda Hospital Association v. Bowen,* 108 S. Ct. 1255, 1257 (1988).

limits in accordance with the wage index methodology which *includes* federal government hospital data. However, after purporting to follow APA notice and comment procedures, the Secretary reissued in November 1984, *strictly for purposes of the 1981 schedule of routine cost limits,* the wage index methodology which *excludes* federal government hospital data. 49 Fed. Reg. 6,175 (proposed rule), J.A. at 15-28; 49 Fed. Reg. 46,495 (final rule), J.A. at 29-47. Based on that retroactive rule, the Secretary's agents reopened respondents' already settled 1981 and/or 1982 cost reports to recoup in 1985 the monies previously paid to respondents. The reopening notices stated that the recoupment was "based on a reversal" of the *DCHA* decision effected through the Secretary's retroactive rulemaking. *See, e.g.,* J.A. at 48.

After exhausting administrative remedies, respondents brought suit for a second time to seek the return of the monies previously paid to them as a result of their first court victory. The district court (*per* Judge Oberdorfer) again ruled in the hospitals' favor. Pet. App. at 20a-42a. The court noted that it is not clear that the Secretary is authorized to apply a retroactive cost limit rule, but found resolution of that question "unnecessary." *Id.* at 33a-34a. Based on the five-pronged "balancing" test established in *Retail, Wholesale and Department Store Union, AFL-CIO v. NLRB,* 466 F.2d 380 (D.C. Cir. 1972) for retroactive adjudicative rules, the court held that the particular retroactive rule issued here, which it characterized as "simply *pro forma*" (Pet. App. at 38a), is substantively invalid as applied to the respondents. *Id.* at 34a-39a. It ordered the Secretary to pay the respondents all amounts recouped through the Secretary's retroactive wage index rule.[8] *Id.* at 42a.

The Secretary appealed. His brief accurately describes the ruling of the court of appeals (Pet. App. at 1a-19a). *See* Brief for the Petitioner ("Brief") at 10-12.

[8] The Secretary has complied with the court's order for all but one of the respondents.

SUMMARY OF THE ARGUMENT

I. The Secretary's 1984 wage index rule is a retroactive Medicare *cost limit* rule. It is invalid because the statutory provision authorizing the Secretary to issue cost limit rules (section 223(b) of the Social Security Amendments of 1972) prohibits the Secretary from issuing *retroactive* cost limit rules. The prospectivity requirement of section 223(b) is plainly reflected in the statutory language, the provision's legislative history, the Secretary's cost limit regulation, the Secretary's prior cost limit schedules, and the Secretary's administrative decisions.

The broad construction of the retroactive corrective adjustments provision presented in the Secretary's brief is simply a *post hoc* rationalization of the Secretary's counsel that conflicts with the plain wording of the provision itself and the construction in the Secretary's long-standing regulations. Moreover, even if the broad construction of the Secretary's counsel were generally correct, it would not assist the Secretary here. With respect to Medicare *cost limit* rules, the express prospectivity requirement established by section 223(b) would override the very general retroactive corrective adjustments provision.

II. The Secretary also exceeded his authority under the APA, which defines a rule as "an agency statement of . . . *future effect*" which "includes the approval or prescription *for the future*" of certain matters. 5 U.S.C. § 551(4) (emphasis added). The legislative history of the APA confirms that Congress intended this provision to be construed in accordance with its plain meaning. The Secretary's 1984 retroactive wage index rule does not comply with the APA's definition of a rule because it is devoid of "future effect." It applies solely to cost reporting years beginning in a fifteen month period that closed more than two years before the 1984 rule was even promulgated.

III. It is well-established that the invalidation of a rule that rescinded an earlier rule generally has the effect of reinstating the earlier rule. Although the invalidation of a rule may be stayed in cases of extreme emergency, Judge Oberdorfer found no such emergency in *DCHA*—a decision not appealed by the Secretary.

The legal error found in *DCHA* is one that by its very nature cannot be cured on a retroactive basis. To have validly put into effect his new wage index rule on July 1, 1981, the Secretary would have had to have completed *by June 1, 1981* (thirty days in advance) the four-step prior notice and comment process mandated by the APA. The legal defect found in *DCHA* is that the Secretary tried to put his new rule into effect on July 1, 1981, without first having undertaken any of the required steps. Since the agency had to complete those steps by June 1, 1981, for the rule to be effective July 1, 1981, it is axiomatic that the agency could not cure its prior failure to comply with the APA by undertaking the steps in 1984.

The courts below properly concluded that the Secretary's 1984 retroactive wage index rule seriously compromised the integrity of the administrative process. Acceptance of the Secretary's "curative" rule would reward the Secretary for his 1981 illegal conduct. It would allow him to achieve as a result of the illegal action taken on June 30, 1981, what he could not have achieved if he had acted lawfully on that date (*i.e.*, an effective date for his new rule of July 1, 1981).

The Secretary errs in suggesting that the invalid 1981 rule furnished adequate notice of the standard ultimately adopted in the Secretary's 1984 retroactive rule. The invalid 1981 rule did not furnish the degree of notice which the Secretary had previously recognized as necessary to allow hospitals sufficient time to adjust to lower cost limits. Moreover, respondents were not required to rely on a patently unlawful rule. They were entitled instead to rely on their legal rights, which they vindicated in *DCHA*.

IV. Even assuming *arguendo* the applicability of a balancing test, the balance clearly falls in respondents' favor. On the one hand, the ill effects of the Secretary's retroactive rule were substantial. On the other hand, the rule furthered no statutory interest. In promulgating the rule, the Secretary failed to take into account many relevant factors and drew conclusions clearly contrary to the evidence before him. The effect was to produce a wage index that is considerably less accurate than the one reinstated in *DCHA* and that, as Judge Oberdorfer found, "resulted in under-reimbursement of [respondents'] legitimate costs—which . . . contravene[s] the purposes of the Medicare statutes."

ARGUMENT

I. THE MEDICARE STATUTE PRECLUDES THE SECRETARY FROM ISSUING A RETROACTIVE COST LIMIT RULE.

A. Section 223(b) Of The Social Security Amendments Of 1972 Strictly Limits The Secretary's Authority To The Establishment Of Prospective Cost Limits.

Section 223(b) of the 1972 Social Security Amendments amended section 1861(v)(1)(A) of the Social Security Act, 42 U.S.C. § 1395x(v)(1)(A), to authorize the Secretary to establish limits on hospital costs *"to be recognized* as reasonable. . . ." App. at 4 (emphasis added). The emphasized language plainly requires the Secretary to establish the limits *before* the beginning of the period to which they apply.

The prospectivity requirement of section 223(b) is reflected in its legislative history. In identical language, both the House and Senate reports specify that the cost limits set thereunder must be "exercised on a *prospective, rather than retrospective, basis* so that the provider would know *in advance* the limits to Government recognition of incurred costs and have the opportunity to act to avoid having costs that are not reimbursable." H.R. Rep. No. 92-231, 92d Cong., 1st Sess. 83 (1971), J.A. at 54 (emphasis added); S. Rep. No. 92-1230, 92d Cong., 2d Sess. 188 (1972), J.A. at 60 (emphasis added). Both reports repeat that "the limits would be defined in advance. . . ." H.R. Rep. at 84, J.A. at 54; S. Rep. at 188, J.A. at 60.

The Secretary has consistently recognized that section 223 authorizes only "prospective" limits. His original cost limit regulation expressly stated: "These limits will be imposed *prospectively*. . . ." 20 C.F.R. § 405.460(a) (1974) (emphasis

added), *published at* 39 Fed. Reg. 20,165 (1974).[9] Five years later, the Secretary added the following language:

> *Prior to the beginning of a cost period to which limits will be applied,* the Secretary will publish a notice in the *Federal Register,* establishing cost limits and explaining the basis on which they were calculated.

42 C.F.R. § 405.460 (1979) (emphasis added), *published at* 44 Fed. Reg. 31,804 (1979). The present cost limit regulation retains both of these provisions requiring prospective application. *See* 42 C.F.R. § 413.30(a)(2), (b)(3) (App. at 5).

Significantly, the Secretary purported to publish his 1984 retroactive wage index rule pursuant to the authority in his cost limit regulation (then codified as 42 C.F.R. § 405.460). *See* 49 Fed. Reg. 6,176, 6,180 (1984) (proposed notice), J.A. at 16, 27; 49 Fed. Reg. 46,501 (1984) (final notice), J.A. at 47. *Thus, the Secretary's retroactive cost limit rule was issued pursuant to a cost limit regulation that prohibits retroactive cost limit rules.*

The Secretary's consistent position is also reflected in his previously published cost limits. The preamble of virtually every proposed and final schedule of routine cost limits ever published by the Secretary has specified that section 223(b) allows the imposition of "prospective limits" on the costs reimbursable under Medicare.[10] Ironically, even the 1984 proposed notice for the Secretary's retroactive wage index rule

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[9] The subsection (a) prospectivity language was omitted when the regulation was revised in 1979, but was restored in 1982. The 1982 preamble explains:

> We are amending 42 CFR 405.460(a) . . . by adding a sentence . . . setting forth the general principle . . . that the limits . . . will be applied on a prospective basis. When we revised the regulations . . . [in 1979], reference to the prospectivity of the limits was inadvertently omitted. *We are now inserting language in the regulation to make it clear that the limits are to be applied prospectively.*

47 Fed. Reg. 43,286 (col. 1) (1982) (emphasis added).

[10] *See* 39 Fed. Reg. 10,313 (1974); 39 Fed. Reg. 20,168 (1974); 40 Fed. Reg. 17,190 (1975); 40 Fed. Reg. 23,622 (1975); 41 Fed. Reg. 18,465 (1976); 41 Fed. Reg. 26,992 (1976); 42 Fed. Reg. 40,948 (1977); 42 Fed.

(footnote continues)

accurately stated that section 223(b) authorizes *"prospective* limits." 49 Fed. Reg. 6,176 (1984) (emphasis added), J.A. at 16. Moreover, in prior schedules, the Secretary had specifically pledged that "[*a*]*ny* . . . *changes* [to the cost limits] will be *prospective* in nature" and "will apply to . . . costs *incurred after the effective date of the changes.*" *See* 42 Fed. Reg. 40,948 (1977) (emphasis added); 42 Fed. Reg. 53,675 (1977) (emphasis added).

The Secretary's consistent position is also reflected in his administrative decisionmaking. In *Beth Israel Hospital v. Blue Cross Association,* CCH Medicare and Medicaid Guide ¶ 31,645 (1981), the Secretary (through his delegate, the Deputy Administrator of the Health Care Financing Administration) held that "prospectivity requires" that "[t]he criteria for setting the limits and the limits themselves . . . be established for all categories prior to the cost reporting period." J.A. at 69-70.

Based on a review of the foregoing authorities, the court of appeals very appropriately noted that "we are astonished that the Secretary now purports to have the authority to promulgate [cost limit] rules on a retroactive basis." Pet. App. at 16a. Significantly, the Secretary's final rule (J.A. at 29-47) made no response to respondents' comment that section 223(b) precludes the Secretary from issuing a retroactive cost limit rule. *See* Rulemaking Record ("Rec.") at 143-144.

The Secretary's 1984 retroactive wage index rule significantly reduced respondents' Medicare cost limits, and consequently their Medicare reimbursement, for their *1981* years. A rule that reduces reimbursement for a period that began more than three years prior to its issuance cannot be considered "prospective." [11] Accordingly, the Secretary's retroactive wage

(footnote continued)

Reg. 53,675 (1977); 43 Fed. Reg. 43,559 (1978); 44 Fed. Reg. 11,612 (1979); 44 Fed. Reg. 31,806 (1979); 45 Fed. Reg. 21,582 (1980); 45 Fed. Reg. 41,868 (1980); 46 Fed. Reg. 7,456 (1981); 46 Fed. Reg. 33,637 (1981); 46 Fed. Reg. 48,010 (1981).

[11] The Secretary states that respondents "refer to no statement by the Secretary that the Medicare Act bars the issuance of a retroactive cost limit rule following judicial invalidation of the Secretary's prior rule on procedural

(footnote continues)

index rule plainly exceeds the Secretary's authority under section 223(b) and is therefore invalid.[12]

B. The Retroactive Corrective Adjustments Provision Does Not Authorize The Secretary To Issue A Retroactive Cost Limit Rule.

The Secretary's counsel argues that the 1984 retroactive wage index rule was authorized by the retroactive corrective adjustments provision (42 U.S.C. § 1395x(v)(1)(A)(ii)). Brief at 40-47. The Secretary never made any such contention during the rulemaking proceedings.[13] Rather, he stated that he

(footnote continued)

grounds." Brief at 35 n.27. But respondents have pointed to numerous statements by the Secretary categorically requiring prospectivity. Significantly, the Secretary can point to *no* agency statement in the first twelve years after the enactment of § 223(b) stating, or even intimating, that cost limits may be established and applied on a retrospective basis *under any circumstances.*

The Secretary also suggests that the invalid 1981 rule furnished the required prospective notice of the standard ultimately adopted in the 1984 retroactive wage index rule. Brief at 36. However, as discussed at length in § III below, the Secretary's reliance on the invalid 1981 rule is misplaced because (1) invalidation had the effect of depriving the rule of any force; (2) the rule was patently invalid at the time of its publication and respondents were entitled to rely on their right to be bound only by rules published in accordance with lawful procedures; and (3) in any event, the 1981 rule failed to furnish the degree of advance notice which the Secretary had previously recognized as necessary.

[12] Affirmance of the judgment below on this basis would not have broad ramifications. No hospital in the country has been subject to any § 223(b) limits for any costs for any cost reporting year beginning after September 30, 1983. *See* Respondents' Brief in Opposition at 17-18.

[13] The Secretary disputes this. Brief at 40-41 n.34. He relies on a string citation at the end of his 1984 rulemaking notices which includes "section 1861(v)(1)," of which § 1861(v)(1)(A)(ii) (the retroactive corrective adjustments provision) is a part. 49 Fed. Reg. 6,180 (1984), J.A. at 27; 49 Fed. Reg. 46,501 (1984), J.A. at 47. But the Secretary's prior schedules of limits, none of which involved retroactivity, also had this same string citation. *See, e.g.,* 44 Fed. Reg. 31,813 (1979); 45 Fed. Reg. 41,880 (1980); 46 Fed. Reg. 33,645 (1981). The obvious reason is that § 1861(v)(1) includes the language added by § 223(b) of the 1972 Social Security Amendments, which language furnishes the Secretary's sole authorization for the issuance of cost limits.

(footnote continues)

was acting pursuant to section 223(b) and purported to justify issuance of a retroactive rule based on unspecified "substantial legal authority" which he apparently believed was applicable to all agencies. *See* 49 Fed. Reg. 6,176 (1984), J.A. at 16; 49 Fed. Reg. 46,497 (1984), J.A. at 36. The Secretary's present contention is, as the court of appeals found (Pet. App. at 16a), nothing more than an impermissible *post hoc* rationalization of the Secretary's counsel. *See Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 50 (1983).

The Secretary's belated contention is also quite clearly wrong. With respect to *cost limit* rules, the general retroactive corrective adjustments provision must be construed in light of the more specific language added by section 223(b). Prior to 1972, the Secretary had no authority to issue *any* Medicare *cost limit* rules, prospective or retrospective. The only provision that grants him the authority to issue such rules is section 223(b). Yet, as discussed above in section I.A., section 223(b) clearly prohibits the issuance of retroactive cost limit rules. Obviously, the retroactive corrective adjustments provision could not authorize the Secretary to issue retroactive cost limit rules when the only statutory authority for the issuance of cost limit rules prohibits the Secretary from issuing them retroactively. As the Secretary concedes, the retroactive corrective adjustments provision "does not override other provisions of the Medicare Act." Petition at 17 n.10. Thus, even if the Secretary's broad

(footnote continued)

The string citation referred to by the Secretary clearly did not put interested persons on notice that the Secretary believed he was acting pursuant to a special delegation of retroactive rulemaking authority in § 1861(v)(1)(A)(ii). Nor is there the slightest hint in the text of the notices that the Secretary, in fact, held this belief. *See* J.A. at 15-47. Not surprisingly, therefore, none of the interested parties which participated in the rulemaking (including respondents) commented on the retroactive corrective adjustments provision. *See* Rec. at 57-212. Consequently, the Secretary is now precluded from relying on the provision to support his action. *See Global Van Lines, Inc. v. ICC*, 714 F.2d 1290, 1297-1299 (5th Cir. 1983), and the excellent discussion of the legislative history of the APA contained therein.

post hoc construction of the retroactive corrective adjustments provision were correct, it would not change the result here because of the special considerations applicable to section 223(b) rules.[14]

It is clear, however, that the *post hoc* construction of the Secretary's counsel is not correct. The provision does not authorize the Secretary to issue retroactive rules. Instead, it *requires* the Secretary to establish regulations that "provide *for the making of* suitable retroactive corrective adjustments . . . ." App. at 3-4 (emphasis added). In other words, Congress ordered the Secretary to issue a regulation that establishes *a process* for making certain "adjustments." "Adjustments," of course, are normally made to "reimbursement" or payments, not regulations. Moreover, these particular "adjustments" are to be made "where, *for a provider of services for any fiscal period, the aggregate reimbursement* produced by the methods of determining costs *proves to be* either *inadequate or excessive.*" *Id.* at 4 (emphasis added). Accordingly, to make the adjustments properly, the Secretary must determine a *particular provider's* "aggregate reimbursement" for a *particular period* and then determine whether that "aggregate reimbursement" was "inadequate or excessive." *Id.* The Secretary can obviously do that only on a case-by-case basis. Thus, the Secretary's *post hoc* suggestion that this provision authorizes the promulgation of retroactive rules of general applicability for *specific* (not aggregate) costs conflicts with the plain wording of the provision.[15]

[14] If the construction of the Secretary's counsel were correct, the prospectivity requirement in the Secretary's cost limit regulation would be meaningless. In the preceding subsection (§ I.A.), respondents furnished 25 separate citations reflecting the Secretary's view that his authority under § 223(b) is limited to establishing and applying cost limits on a "prospective" basis. Not once did the Secretary suggest that the prospectivity requirement was subject to *any* exceptions.

[15] The Secretary's *post hoc* construction ignores an important difference in scope between § 223(b) and the retroactive corrective adjustments provision. Section 223(b) authorizes the establishment of limits on "overall incurred costs or incurred costs of *specific* items or services" App. at 4 (emphasis added). But the retroactive corrective adjustments provision

(footnote continues)

The Secretary has, in fact, *never* published any regulation that has set up a process for issuing retroactive rules. He has, however, published regulations that have set up a process for the making of retroactive adjustments on a case-by-case basis. These regulations, which date from 1966, require the Secretary's agents to make retroactive adjustments for each provider to reconcile the amount to which the provider is entitled after a full audit with the amount of estimated payments received by the provider during the year. *See* 42 C.F.R. § 413.64(a)(1), (b), (f) (App. at 5-7); 42 C.F.R. § 413.9(b)(1) (App. at 4-5).

The Secretary argues in his brief that under *Chevron U.S.A., Inc. v. NRDC, Inc.*, 467 U.S. 837 (1984), the Secretary's construction must be upheld because it is a possible reading of the statutory language. Brief at 14, 42. However, even assuming *arguendo* that the construction presented in the Secretary's brief is a possible reading, the Secretary begs the question of what is properly regarded as the "Secretary's construction." The authoritative source of an agency's construction must surely be its own regulations. Here the Secretary's regulations contradict the construction of the retroactive corrective adjustments provision presented in the Secretary's brief. Significantly, the statement of the "Secretary's view" in his brief is unaccompanied by any citation. *See* Brief at 42. Moreover, the Secretary makes no attempt in his brief to reconcile the "view" presented therein with that presented in his regulations.

(footnote continued)

comes into play only when "*aggregate* reimbursement . . . proves to be either inadequate or excessive." *Id.* at 3-4 (emphasis added).

The Secretary's 1984 retroactive wage index rule applies only to a "specific" item, i.e., wages attributable to "inpatient general routine operating costs." 49 Fed. Reg. 6,176 (1984), J.A. at 17. It does not apply to the cost of special care units or ancillary services or to medical education, capital, or outpatient costs or even to the non-wage component of "inpatient general routine operating costs." 46 Fed. Reg. 33,637 (1981). (According to Georgetown University Hospital's audited Medicare cost report for its fiscal year beginning July 1, 1981, the hospital's total (*i.e.*, wage and non-wage) "inpatient general routine operating costs" accounted for only 36.2% of its "aggregate" Medicare reimbursement.) Thus, the Secretary's reliance on the retroactive corrective adjustments provision must fail because, among other things, there is not the slightest hint that, in promulgating the retroactive wage index rule, the Secretary gave any consideration to "aggregate reimbursement"—a controlling consideration under the plain wording of the retroactive corrective adjustments provision.

The *post hoc* construction of the retroactive corrective adjustments provision presented in the Secretary's brief also conflicts with the construction adopted by the agency near the time of the provision's enactment. In congressional hearings held in 1966, Robert M. Ball, then Commissioner of the Social Security Administration (the agency originally responsible for administering the Medicare program), stated that the provision does not authorize the agency to change reimbursement rules retroactively and, consistent with the regulations issued shortly thereafter, construed the provision as simply requiring a year-end reconciliation based on the results of a final audit.[16] *See Daughters of Miriam Hospital Center for the Aged v. Mathews*, 590 F.2d 1250, 1258-1259 n.23 (3d Cir. 1978). An agency's

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[16] Commissioner Ball testified:

> Payments [to Medicare providers] will be made for services throughout the year and final settlement on a retroactive basis will be made at the end of the accounting period. Continuing payments will be made as often as possible and in no event less frequently than once a month. The retroactive payments will take fully into account costs as they were actually incurred, *determined according to the agreed upon principles of reimbursement—we don't retroactively change the principles*—and settlement will be on an incurred rather than on an estimated basis.

Reimbursement Guidelines for Medicare, Hearings Before the Senate Committee on Finance, 89th Cong., 2d Sess. 56 (1966) (emphasis added).

> *I don't think that the retroactive provision contemplates going back over the year and changing the principles.*
>
> * * * *
>
> [Y]ou make an estimate at the beginning of the year on the basis of these principles. Then at the end of the year you settle up, on the basis of the principles put out.
>
> It would hardly seem reasonable at the end of the year, after hospitals had entered into an agreement with you on the basis of certain principles, to shift all the principles for retroactive settlement in terms of how you compute a cost. *I don't think that was contemplated at all.*

Id. at 119 (emphasis added).

contemporaneous construction is, of course, entitled to considerable deference.[17] *General Electric Co. v. Gilbert,* 429 U.S. 125, 141-142 (1976).

The Secretary's *post hoc* construction also conflicts with the legislative history accompanying the enactment of section 223(b). Both the House and Senate reports expressly state that "present law generally limits exercise of the authority to disallow costs to instances that can be specifically proved on a *case-by-case basis.*" [18] H.R. Rep. No. 92-231 at 83, J.A. at 53; S. Rep. No. 92-1230 at 188, J.A. at 59. Thus, Congress obviously did not believe in 1972 that the retroactive corrective adjustments provision granted the Secretary broad authority to disallow costs through the issuance of retroactive rules of general applicability.[19]

This Court has not looked kindly upon the *post hoc* rationalizations of agency counsel in general. *See Motor Vehicle Manufacturers Association,* 463 U.S. at 50; *Burlington*

[17] In *Heckler v. Community Health Services of Crawford County, Inc.,* 467 U.S. 51, 53-54 (1984), this Court adopted the same construction of the retroactive corrective adjustments provision contained in the Secretary's regulations and reflected in Commissioner Ball's congressional testimony:

> Providers receive interim payments at least monthly covering the cost of services they have rendered. [42 U.S.C.] § 1395g(a). Congress recognized, however, that these interim payments would not always correctly reflect the amount of reimbursable costs, and accordingly instructed the Secretary to develop mechanisms for making appropriate retroactive adjustments when reimbursement is found to be inadequate or excessive. § 1395x(v)(1)(A)(ii).

[18] The Secretary's discussion of the legislative history is contradictory. On the one hand, he alleges that the legislative history "never even mentions Clause (ii), let alone discusses the relationship of Clause (ii) to the Secretary's authority to promulgate cost limit rules." Brief at 45 (footnote omitted). But elsewhere he concedes that "the House and Senate reports contrast the Secretary's new authority to issue cost limit rules with the prior medicare cost reimbursement scheme, under which excessive costs *could be disallowed only on a case-by-case basis.*" *Id.* at 34-35 (emphasis added).

[19] There is no discussion of the retroactive corrective adjustments provision in the 1965 legislative history. This is in itself revealing. It seems certain that the legislative history would have discussed the provision at some length if Congress had intended to delegate to the Secretary special authority to promulgate retroactive rules.

Truck Lines, Inc. v. United States, 371 U.S. 156, 168 (1962). There is even less reason to do so when, as here, the *post hoc* construction conflicts with the plain wording of the statute, the legislative history, the agency's own regulations, and the agency's prior representations to Congress.[20]

II. THE ADMINISTRATIVE PROCEDURE ACT GENERALLY BARS THE SECRETARY FROM ISSUING A RULE, LIKE THE 1984 RETROACTIVE WAGE INDEX RULE, WHICH HAS "PRIMARY" RETROACTIVE EFFECT.

In discussing retroactivity, it is important to distinguish between two different types—"primary" and "secondary." *See* McNulty, *Corporations and the Intertemporal Conflict of Law,* 55 Calif. L. Rev. 12, 57-61 (1967). A rule involves primary retroactivity if it alters the legal consequences of past events *as of the date the events occurred.* An example of primary retroactivity is a rule issued on January 1, 1988, that makes unlawful an act that occurred in 1986. A rule involves secondary retroactivity if it operates prospectively, but affects, as of the date of its adoption, the future legal consequences of an earlier action. An example of secondary retroactivity is a rule issued on January 1, 1988, which affects the future legal consequences of an ongoing activity commenced in 1982, but not completed until 1992. Many rules have some secondary retroactive effect, but primary retroactivity is rare.[21]

[20] There is also merit to the court of appeals' view that "just as substantive legislation will not be given retroactive effect 'unless such be 'the unequivocal and inflexible import of the statutory terms, and the manifest intention of the legislature,'' an organic statute will not be read to authorize an agency to engage in retroactive rulemaking unless it is clear from the terms of the statute that Congress intended such an unusual delegation of power." Pet. App. at 14a-15a (footnote omitted). As this Court has stated, "[t]he power [of an agency] to require readjustments for the past is drastic. . . . [I]t ought not to be extended so as to permit unreasonably harsh action *without very plain words.*" *Brimstone Railroad and Canal Co. v. United States,* 276 U.S. 104, 122 (1928) (emphasis added).

[21] Prior to 1986, many individuals purchased capital assets in the expectation that any gain realized on the sale of such assets would be taxed at a capital gains tax rate. By repealing the capital gains tax rate, the Tax

(footnote continues)

The APA clearly establishes a general rule against the promulgation of rules having *primary* retroactive effect.[22] It defines a rule as "an agency statement of . . . *future effect*" which "includes the approval or prescription *for the future*" of certain matters. 5 U.S.C. § 551(4) (emphasis added), App. at 1.[23] Statements of the legislation's sponsors [24] and passages from the *Attorney General's Manual on the APA*[25] confirm that Congress meant exactly what it said. So does a decision of this Court issued one year after the APA was enacted. *See SEC v.*

(footnote continued)

Reform Act of 1986 defeated that expectation *for the future*, thereby having a secondary retroactive effect. The 1986 Act would have had a primary retroactive effect if it had repealed the capital gains tax effective as of 1982 and mandated the reassessment of taxes for 1982-1985 tax years.

[22] Respondents do not contend that there can *never* be exceptions to this general rule. Extraordinary circumstances may arise where even primary retroactivity is unavoidable. For instance, some retroactivity may be necessary where an agency altogether fails to issue regulations to implement a *new* program by the date mandated by Congress. However, as Judge Oberdorfer ruled in another case involving the Secretary, in such circumstances special care must be taken so that interested parties are not unduly harmed by the retroactivity necessitated by the agency's failure to comply with Congress' commands. *See National Association of Rehabilitation Facilities, Inc. v. Schweiker*, 567 F. Supp. 47, 51-53 (D.D.C. 1983).

[23] The Secretary argues that the APA definition simply means that "any application or enforcement will occur *only in the future, i.e.*, in an adjudication." Petition at 19 (original emphasis). Aside from conflicting with the plain wording of the statutory provision (which uses the words "for the future," not "in the future"), the Secretary's construction is contradicted by what happened here. The Secretary enforced his 1984 retroactive wage index rule without the benefit of "an adjudication"; he simply recouped from the respondents' Medicare payments the amounts previously paid under *DCHA*.

[24] *See* Proceedings from the Congressional Record, *Legislative History of the Administrative Procedure Act, 1944-1946*, at 355 ("In rule making an agency is not telling someone what his rights or liabilities are for past conduct or present status under existing law. Instead, in rule making the agency is prescribing what *the future law shall be* so far as it is authorized so to act." (emphasis added)) (remarks of Congressman Francis E. Walter); *id.* at 374 ("[The bill] requires that . . . rules or regulations which have the effect of law must . . . go into effect at some future date.") (remarks of Congressman John W. Gwynne).

[25] *See* Justice Department, *Attorney General's Manual on the Administrative Procedure Act* 13 (1947) ("Of particular importance is the fact that

(footnote continues)

Chenery Corp., 332 U.S. 194, 202 (1947) ("Since the Commission, unlike a court, does have *the ability to make new law prospectively through the exercise of its rule-making powers,* it has less reason to rely upon ad hoc adjudication to formulate new standards of conduct. . . . The function of filling in the interstices of the Act should be performed, as much as possible, through this *quasi-legislative promulgation of rules to be applied in the future.*" (emphasis added)).

The Secretary relies on a passage from the report of the House Judiciary Committee which states that "[t]he phrase 'future effect' does not preclude agencies from considering and, so far as legally authorized, dealing with past transactions in prescribing rules for the future." Brief at 32. However, that passage supports respondents, not the Secretary. "[D]ealing with past transactions in prescribing rules *for the future*" is different from prescribing rules for the past. (Emphasis added.) It is *primary* retroactivity, not secondary retroactivity, that is involved in this case and that is generally prohibited by the APA.

The Secretary also relies on the following passage in the *Attorney General's Manual on the APA:* "Nothing in the Act precludes the issuance of retroactive rules when otherwise legal and accompanied by the finding [of good cause] required by [5 U.S.C. § 553(d)]. H.R. REP. p. 49, fn.1 (Sen. Doc. p. 283)." *Manual* at 37. However, that passage expressly cites as authority the passage from the House Judiciary Committee

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(footnote continued)

'rule' includes agency statements not only of general applicability but also those of particular applicability applied either to a class or to a single person. In either case, they must be of *future effect,* implementing or prescribing future law." (original emphasis)); *id.* at 14 ("Rule making is agency action which *regulates the future conduct* of either groups of persons or a single person; it is essentially legislative in nature, not only because it operates in the future but also because it is primarily concerned with policy considerations. The object of the rule making proceeding is the implementation or prescription of law or policy *for the future, rather than the evaluation of a respondent's past conduct.*" (emphasis added)); *id.* at 128 ("[5 U.S.C. § 553(d)] is not intended to hamper the agencies in cases in which there is good cause for putting a rule into effect immediately, or at some time earlier than thirty days.").

report examined in the preceding paragraph of this brief. Thus, the Attorney General was simply using the term "retroactive rules" loosely to describe rules that deal with past transactions in prescribing standards for the future, *i.e.,* rules involving *secondary* retoractivity. This is confirmed by other passages in the *Manual* that clearly reflect that the Attorney General did not believe that the APA allows an agency to prescribe rules for the past, *i.e.,* rules involving *primary* retroactivity. *See* note 25 above. The passage cited by the Secretary does not, in any event, help the Secretary here because the 1984 retroactive wage index rule was not accompanied by a "good cause" finding (*see* 49 Fed. Reg. 46,495-46,501 (1984), J.A. at 29-47) and, as the court of appeals expressly found, does not come "within any conceivable 'good cause' exception" (Pet. App. at 12a n.11).[26]

The 1984 retroactive wage index rule is totally devoid of "future effect." It applies solely to cost reporting years beginning in a fifteen month period that closed more than two years before the 1984 rule was even promulgated. Accordingly, by promulgating the 1984 retroactive wage index rule, the Secretary exceeded the scope of his rulemaking authority under the APA.[27]

III. THE SECRETARY'S "CURATIVE RULEMAKING" DEFENSE IS UNSUPPORTED BY LAW AND AN AFFRONT TO THE INTEGRITY OF THE ADMINISTRATIVE PROCESS.

1.a. As the *DCHA* court noted (Pet. App. at 63a), the APA provides that a "reviewing court *shall* . . . hold unlawful and *set aside* agency action . . . found to be . . . without observance of procedure required by law." 5 U.S.C. § 706(2)(D)

[26] 5 U.S.C. § 553(d)(3) allows an exception to the normal thirty day delayed effective date requirement "for good cause found and published with the rule." App. at 2. However, the plain wording of the exception only allows an agency to make a rule effective immediately or in less than thirty days, not retroactively.

[27] The APA and § 223(b) furnish *alternative* grounds for invalidating the Secretary's rule; either is sufficient by itself for invalidation.

(emphasis added) (App. at 2). To "set aside" or "vacate" is to " 'annul; . . . cancel or rescind; . . . declare, . . . make, or . . . render, void; . . . defeat; . . . deprive of force; . . . make of no authority or validity. . . .' " *See Action on Smoking and Health v. CAB,* 713 F.2d 795, 797 (D.C. Cir. 1983). Since invalidation deprives a rule of any force, it follows logically that the usual effect of invalidating a rule that purports to repeal an earlier rule is to leave in place the earlier rule.

The lower courts' conclusion here that the invalidation of a rule generally has this effect (Pet. App. at 13a, 32a) is in accord with the holdings of this Court and other courts of appeals. *See, e.g., United States v. Baltimore and Ohio Railroad Company,* 284 U.S. 195, 203-204 (1931); *Mason General Hospital v. Secretary of Department of Health and Human Services,* 809 F.2d 1220, 1223, 1229 (6th Cir. 1987); *Tallahassee Memorial Regional Medical Center v. Bowen,* 815 F.2d 1435, 1453 n.35, 1455-1456 (11th Cir. 1987), *cert. denied,* 108 S.Ct. 1573 (1988); *Abington Memorial Hospital v. Heckler,* 750 F.2d 242, 244 (3d Cir. 1984), *cert. denied,* 474 U.S. 863 (1985); *Lloyd Noland Hospital and Clinic v. Heckler,* 762 F.2d 1561, 1569 (11th Cir. 1985); *Menorah Medical Center v. Heckler,* 768 F.2d 292, 297 (8th Cir. 1985); *Cumberland Medical Center v. Secretary of Health and Human Services,* 781 F.2d 536, 538-539 (6th Cir. 1986); *DeSoto General Hospital v. Heckler,* 766 F.2d 182, 186, *modified on rehearing,* 766 F.2d 186, *original opinion reinstated on rehearing of rehearing,* 776 F.2d 115, 116 (5th Cir. 1985). This general rule has been applied in numerous instances in which the invalidation was based on an agency's failure to comply with the notice and comment procedures of the APA. *See, e.g., Action on Smoking and Health,* 713 F.2d at 797; *W.C. v. Bowen,* 807 F.2d 1502, 1505-1506, *as corrected at,* 819 F.2d 237, 238 (9th Cir. 1987); *Natural Resources Defense Council, Inc. v. U.S. EPA,* 683 F.2d 752, 767-769 (3d Cir. 1982); *Levesque v. Block,* 723 F.2d 175, 187-189 (1st Cir. 1983); *Brown Express, Inc. v. United States,* 607 F.2d 695, 703 (5th Cir. 1979).

Exceptions to this general rule may be appropriate in rare cases. As Judge Oberdorfer noted in *DCHA,* courts have sometimes exercised their equitable powers to stay invalidation

in cases of extreme emergency. Pet. App. at 61a. However, Judge Oberdorfer found no such emergency in *DCHA* and specifically refused to grant the Secretary's request for a stay of invalidation. *Id.* If the Secretary was dissatisfied with that determination, he should have appealed and requested a stay of Judge Oberdorfer's *DCHA* decision.

Although the Secretary contends that invalidation of the 1981 wage index rule did not restore the preexisting wage index methodology, his contention is contradicted by his own actions. Following *DCHA,* the Secretary, in fact, settled respondents' Medicare cost reports in accordance with the preexisting wage index methodology. Pet. App. at 13a, 32a. Moreover, his 1985 reopening notices stated that the reopenings were "based on a reversal" of *DCHA* effected through the Secretary's retroactive rule. *See, e.g.,* J.A. at 48.

It should be noted that the remedy applied here was quite narrow. Invalidation of the 1981 wage index rule did not exempt respondents from the Secretary's cost limits. It simply meant that the Secretary's preexisting wage index methodology (which included federal government hospital data) had to be used in determining the amount of respondents' limits. Respondents have not challenged the Secretary's disallowances to the extent that they resulted from the application of the cost limits as computed under that methodology.

Nor was the Secretary necessarily precluded from disallowing costs that were below the cost limits. The Secretary was still able to disallow a particular hospital's costs to the extent that he found them to be "substantially out of line with [the costs of] other institutions in the same area that are similar in size, scope of services, utilization, and other relevant factors." 42 C.F.R. § 413.9(c)(2), formerly 20 C.F.R. § 405.451(c)(2) (1966); *Memorial Hospital/Adair County Health Center, Inc. v. Bowen,* 829 F.2d 111 (D.C. Cir. 1987). But the Secretary settled all of respondents' cost reports without making any such determination.

The remedy applied here simply gave effect to what the Secretary purported to be doing in issuing the 1981 schedule. The Secretary stated in his 1981 notice that a Regulatory Impact Analysis was not required because "this notice merely

updates economic factors employed in the *existing methodology and does not modify the methodology used to compute the limits in any manner."* 46 Fed. Reg. 33,640 (col. 2) (1981) (emphasis added). Moreover, he found "good cause" for dispensing with notice and comment procedures because the agency developed the limits "by using *the same methodology* . . . used to develop the current [1980] hospital limits."[28] *Id.* (emphasis added). The remedy applied by the courts below does what the Secretary said he was doing; it uses "the same methodology" used for the 1980 limits.

b. The Secretary contends that respondents' "argument is identical to the argument that this Court rejected in *Chenery.*" Brief at 16 n.7. There are, in fact, several very significant distinctions between this case and *Chenery.*

First, *Chenery* involved adjudication, not APA rulemaking—a distinction which, as discussed in section II above, the *Chenery* Court was very careful to draw. 332 U.S. at 202. Indeed, the Court specifically noted that if the agency had proceeded by legislative rulemaking, "the issue . . . would have been entirely different. . . ." *Id.* at 201.

Adjudication, unlike rulemaking, is by its very nature retroactive. By its initial 1941 decision in *Chenery,* the SEC sought to establish, as it was entitled to do, adjudicative rules (or, in APA terminology, "orders" (5 U.S.C. § 551(6)-(7)) applicable to earlier conduct occurring in the period 1937-1940. Following this Court's 1943 remand, the SEC issued a second decision in 1945 which properly explicated the basis of its 1941 decision. By upholding that second decision, the Court did not allow the SEC to do retroactively what otherwise it would have been required by law to do prospectively. Even if the SEC had adequately explained the basis of its decision in 1941, the SEC's decision would have been retroactive—and, because the agency was exercising an *adjudicative* function, properly so. Here, however, because the Secretary was exercising a *legislative* function and doing so in the context of Medicare *cost limit* rules,

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[28] The Secretary did not mention the exclusion of federal government hospital data in either his Regulatory Impact Analysis statement or his "good cause" statement. The only reference to the exclusion is found in a short three-sentence paragraph earlier in the notice. *See* 46 Fed. Reg. 33,639 (col. 1) (1981).

retroactivity was improper *ab initio.* Indeed, as discussed in sections I and II above, two discrete statutory provisions bar the retroactive promulgation and application of Medicare cost limit rules. No such statutory bars faced the SEC in *Chenery.*

Second, in *Chenery,* there was no preexisting rule to fall back on. The SEC "had not previously been confronted with the problem of management trading during reorganization. . . ." 332 U.S. at 203; *see* K. Davis, *Administrative Law Treatise* § 17.09 (1958) ("It is retroactive change in settled law, not retroactive clarification of uncertain law, that may be unfair, and the law or policy that the SEC was changing or developing [in *Chenery*] was highly uncertain, not settled."). Retroactivity was unavoidable because "[e]very case *of first impression* has a retroactive effect, whether the new principle is announced by a court or by an administrative agency." 332 U.S. at 203 (emphasis added). Thus, invalidation of the first agency decision in *Chenery* left a void that needed to be filled.[29] Here, in contrast, "invalidation of the 1981 wage index and formula would leave in place the formula that was arrived at after proper notice and comment procedures and was used successfully to reimburse providers prior to July 1981." *DCHA,* Pet. App. at 61a.

Third, in its first *Chenery* decision, the SEC did not violate any statutory requirements. It simply failed to furnish an explanation of its decision adequate to allow for meaningful judicial review. 332 U.S. at 196-197. Remanding for a further explanation did not place the agency in a better position than it would have been in if it had provided an adequate explanation in its original decision. Here, in contrast, the Secretary's 1981 action violated the express requirements of the APA. Moreover, as will be discussed at length below, upholding the

[29] This was also true in *Addison v. Holly Hill Fruit Products, Inc.,* 332 U.S. 607 (1944), the other case on which the Secretary principally relies. Brief at 16, 28 n.20. In *Addison,* the Court stated that "law should avoid retroactivity as much as possible," but nonetheless allowed retroactive rulemaking because "other possible dispositions likewise involve retroactivity, with the added mischief of producing a result contrary to the statutory design." 332 U.S. at 620; *see also* K. Davis, *Administrative Law Treatise* § 7:23 at 110 (1979) ("The problem [in *Addison*] was not whether to make law retroactively but what law to make retroactively. . . .").

Secretary's 1984 retroactive wage index rule would reward the Secretary for his illegal conduct. It would allow him to achieve as a result of the illegal action taken on June 30, 1981, what he could not have achieved if he had acted lawfully on that date.

Finally, this Court's first *Chenery* decision expressly remanded the case to the SEC for further action. *See SEC v. Chenery Corp.,* 318 U.S. 80, 95 (1943). But Judge Oberdorfer did not "remand" to the agency in *DCHA;* the word "remand" will not be found anywhere in his judgment or opinion. Instead, he issued declaratory relief, noting that, in processing respondents' specific claims, "the Secretary and [his] delegates . . . are, of course, obligated to follow the law as it is finally interpreted by the Court." Pet. App. at 63a. Nothing in his opinion or judgment (which was not appealed by the Secretary) furnishes any authorization for retroactive rulemaking. To the contrary, Judge Oberdorfer's opinion specifies that "[i]f the Secretary wishes to put in place a valid *prospective* wage index, [he] should begin proper notice and comment proceedings. . . ." *Id.* at 64a (emphasis added).

2.a. The Secretary argues that by following APA notice and comment procedures in 1984, he "*corrected* the legal error" found in *DCHA.* Brief at 20 (original emphasis). But that "legal error" is one that by its very nature cannot be corrected retroactively.

Under the APA, an agency must normally follow four steps to effect a substantive change in policy as of a certain date. Specifically, it must publish a notice of the proposed rule; allow interested persons an opportunity to participate; consider relevant comments and materials furnished by the public; and publish the final rule accompanied by a statement of the rule's basis and purpose. 5 U.S.C. § 553(b)-(c) (App. at 1-2). If the agency fails to complete these procedures within thirty days of the desired effective date, it is normally precluded from making a new rule effective on that date.[30] 5 U.S.C. § 553(d) (App. at

[30] "Good cause" exceptions are available in very limited circumstances. *See* 5 U.S.C. § 553(b)(B), (d)(3). However, *DCHA* held that the Secretary had failed to show "good cause" for waiving the normal procedures, a holding not appealed by the Secretary. Pet. App. at 58a-60a.

2). It can make the change in policy effective thirty days after it has completed the required prerequisites, but it cannot make the change retroactive to the date that it originally intended. *See United States v. Gavrilovic,* 551 F.2d 1099, 1103-1105 (8th Cir. 1977); *Rowell v. Andrus,* 631 F.2d 699, 702-704 (10th Cir. 1980); *Ngou v. Schweiker,* 535 F. Supp. 1214, 1216-1217 (D.D.C. 1982).

The "legal error" found in *DCHA* was that the agency failed to undertake before July 1, 1981, any of the four steps which it had to complete before that date in order to make its new wage index rule effective on that date. Since the agency had to complete those steps by June 1, 1981 (thirty days in advance) for the rule to be effective on July 1, 1981, it is axiomatic that the agency could not cure the "legal error" by undertaking the steps in 1984.

The Secretary complains that the lower courts allowed respondents to convert a "procedural victory into a substantive victory." [31] Brief at 18. However, the same complaint could be made by any party that failed to meet a filing deadline or a statute of limitations. For instance, under the Medicare statute (42 U.S.C. 1395oo(f)(1)), a hospital dissatisfied with a final agency reimbursement decision must file a court suit within sixty days. Should a hospital that waited until the seventieth day be heard to argue that the late filing must be given retroactive effect to prevent the Secretary from converting a "procedural" victory into a "substantive" victory? Obviously, if the hospital failed to meet the deadline set by Congress, the Secretary is entitled to his victory, whether it be characterized as "procedural" or "substantive." Properly analyzed, the instant case involves not an attempt by the respondents to convert a procedural victory into a substantive victory, but an attempt by the Secretary to convert a defeat (in the form of a final adverse court judgment) into a victory.

[31] By failing to comply with the notice and comment procedures of the APA, the agency made it impossible for respondents to challenge the 1981 wage index rule on substantive grounds in *DCHA*. A substantive challenge must be based on the rulemaking record. *See Walter O. Boswell Memorial Hospital v. Heckler,* 749 F.2d 788, 792-794 (D.C. Cir. 1984). But there is no rulemaking record where the agency has dispensed with notice and comment procedures.

The Secretary appears to equate "procedural" with "insignificant." But certainly in the case of APA notice and comment procedures, that is not a fair equation. As this Court has recognized specifically with respect to these procedures, "agency discretion is limited not only by substantive, statutory grants of authority, but also by the procedural requirements which 'assure fairness and mature consideration of rules of general application.'" *Chrysler Corp. v. Brown,* 441 U.S. 281, 303 (1979) (quoting *NLRB v. Wyman-Gordon Co.,* 394 U.S. 759, 764 (1969)). Indeed, "[g]iven the lack of supervision over agency decisionmaking that can result from judicial deference and congressional inattention, . . . [APA notice and comment procedures], as a practical matter, may constitute an affected party's only defense mechanism." *Chamber of Commerce of United States v. OSHA,* 636 F.2d 464, 470 (D.C. Cir. 1980). *Accord, Natural Resources Defense Council, Inc. v. U.S. EPA,* 824 F.2d 1258, 1286 (1st Cir. 1987) ("since a reviewing court normally gives deference to the Agency's substantive conclusions in complex regulatory matters, we will insist that the required procedures be strictly complied with."). A court that defers to an agency's substantive decision can at least have some confidence that the decision is fair if the agency followed fair and lawful procedures in reaching the decision.

b. The courts below were properly concerned about the integrity of the administrative process. Judge Oberdorfer concluded that the procedure followed by the Secretary had "trivialized the APA" and that "the ill effects of the Secretary's action are substantial for these plaintiffs and for the general integrity of the administrative rule-making process." Pet. App. at 37a, 38a. The court of appeals agreed, stating that acceptance of the Secretary's position would "make a mockery of the provisions of the APA" and noting that "agencies would be free to violate the rulemaking requirements of the APA with impunity if, upon invalidation of a rule, they were free to 'reissue' that rule on a retroactive basis." *Id.* at 14a; *see also Mason General Hospital,* 809 F.2d at 1231 ("in the context of administrative rulemaking, [retroactivity] trivializes the procedures mandated by the Administrative Procedure Act.").

A simple hypothetical demonstrates the validity of their conclusions. Suppose that each of three agencies decided in June 1981 that it wanted to change one of its rules. Although Agencies *A* and *B* wanted to do so immediately, they realized they could not do so consistently with the APA. Accordingly, they both proceeded to prepare and publish a notice of proposed rulemaking. After analyzing the public comments, Agency *A* decided there was merit to its proposed rule; it published the rule in final on September 1, 1982,[32] and, consistent with 5 U.S.C. § 553(d), made the rule effective October 1, 1982. On the other hand, Agency *B* was persuaded by the public comments that its proposed rule was unwise, causing it to abandon its original plans altogether.

Like Agencies *A* and *B*, Agency *C* also wanted to change its rule immediately, but, unlike the other agencies, it decided to dispense with notice and comment procedures. It published the new rule in final form on June 30, 1981, to be effective the following day. The rule was subsequently invalidated because of Agency *C*'s failure to follow notice and comment procedures, but in 1984, Agency *C* republished the rule, after following notice and comment procedures, and once again made the rule effective July 1, 1981. Agency *C*, of course, followed the exact course of the Secretary in this case.

Should Agency *C* be allowed to make its 1984 rule effective July 1, 1981? If so, Agency *C* has been rewarded for violating the notice and comment procedures mandated by Congress. As a result of its original illegal action, Agency *C* has been able to achieve what Agencies *A* and *B* wanted to do but by acting lawfully were unable to do. If Agency *C* can do this, why should any agency that wants to make a rule effective immediately bother to comply with APA public participation procedures in the future? If it does not comply, its rule might not be challenged, in which case it has avoided the inconvenience of rulemaking procedures altogether, and, if the rule is challenged, the agency can easily achieve its original purpose

[32] The rulemaking record reflects that the Secretary began to prepare the retroactive wage index rule on August 12, 1983. Rec. at 273. The final rule was published on November 26, 1984—fifteen and a half months later.

by simply pursuing retroactive rulemaking. In either event, it will be able to achieve the desired immediate effectiveness for its rule that it could not have achieved by originally complying with the *prior* notice and comment rulemaking procedures mandated by the APA.

Stripped of rhetoric, the Secretary's argument asks nothing less than that this Court reward him for violating the notice and comment procedures of the APA.[33] If accepted, it would, as the court of appeals correctly observed, allow agencies "to violate the rulemaking requirements of the APA with impunity. . . ." Pet. App. at 14a. But to allow this would clearly be contrary to Congress' direction that "[i]t will . . . be the duty of reviewing courts to prevent avoidance of the requirements of the bill *by any manner or form of indirection*. . . ." S. Rep. No. 752, 79th Cong., 1st Sess. (1945), *reprinted in Legislative History of the Administrative Procedure Act, 1944-1946,* at 217 (emphasis added); *see also Chrysler Corp. v. Brown,* 441 U.S. at 313 ("courts are charged with . . . ensuring that agencies comply with the 'outline of minimum essential rights and procedures' set out in the APA."). The integrity of the rulemaking process requires rejection of the Secretary's "curative" rulemaking argument.[34]

[33] Faced with a similar "curative" retroactive rule issued by the Secretary, the Court of Appeals for the Eleventh Circuit aptly noted:

> In football, if a team gains ten yards on a play in which it commits a five yard penalty, the ball is typically taken back to the original line of scrimmage and the five yard penalty is counted off from there. Adopting the Secretary's approach would be like taking five yards off from the point where the play ended (and thus allowing the team a net five yards gain on a play in which it committed an infraction).

Tallahassee, 815 F.2d at 1455 n.41.

[34] The logical consequences of the Secretary's position are startling. In *Morton v. Ruiz,* 415 U.S. 199 (1974), this Court rejected the government's position that Indians must actually live *on* reservations to qualify for general assistance. It did so in substantial part because the government's rule had not been published in compliance with the APA. 415 U.S. at 230-236. Under the Secretary's "curative" approach, the government would be free to reinstate the "on reservation" rule retroactively by a "curative" publication in accordance with the APA and then proceed to recoup from Mr. Ruiz the amounts he received as a result of this Court's decision.

The Secretary contends that interested parties have the same opportunity to persuade an agency of the error of a proposed rule in notice and comment proceedings undertaken in a curative retroactive rulemaking that they would have had in prospective rulemaking procedures. Brief at 20-21. But, as a practical matter, that is very unlikely. Returning to our hypothetical involving the three agencies which all wanted to make a change in their rules effective immediately, is it really likely that interested persons would have the same opportunity to persuade Agency *C* of the error of its position that they would have to persuade Agency *B*? Having already tried to adopt its proposal as a final rule, Agency *C* is almost certain to be much less open to the criticisms of interested parties than Agency *B*, which has made no such prior commitment to its proposal.[35] Moreover, Agency *C* may have taken actions based on its prior invalidated rule that would cause the agency inconvenience or embarrassment if it accepted commenters' objections to its "curative" proposed retroactive rule—a powerful psychological factor which might well cause it to reject commenters' criticisms but which obviously would not enter into Agency *B*'s evaluation of the public comments.[36]

[35] This concern accounts in part for the many judicial decisions refusing to allow agencies to substitute a postpromulgation comment period for the *prior* notice and comment procedures mandated by the APA. *See, e.g., Natural Resources Defense Council,* 683 F.2d at 767-769; *State of New Jersey v. U.S. EPA,* 626 F.2d 1038, 1049-1050 (D.C. Cir. 1980); *Sharon Steel Corp. v. EPA,* 597 F.2d 377, 381 (3d Cir. 1979); *U.S. Steel Corp. v. EPA,* 595 F.2d 207, 214-215 (5th Cir. 1979), *cert. denied,* 444 U.S. 1035 (1980); *National Tour Brokers Association v. United States,* 591 F.2d 896, 901-903 (D.C. Cir. 1978). As the D.C. Circuit stated in *National Tour Brokers,* a major purpose of requiring prior notice is:

> to see to it that the agency maintains a flexible and open-minded attitude towards its own rules, which might be lost if the agency had already put its credibility on the line in the form of "final" rules. People naturally tend to be more close-minded and defensive once they have made a "final" determination.

591 F.2d at 902 (footnote omitted).

[36] The Secretary, in fact, attempts to rely on such factors to support promulgation of his 1984 retroactive wage index rule. Brief at 20, 38. The

(footnote continues)

Moreover, if the Secretary can apply a "second-chance" retroactive rule against the respondents, what is to prevent him from imposing a "third-chance" retroactive rule if the "second-chance" retroactive rule fails or from imposing a "fourth chance" retroactive rule if the "third-chance" retroactive rule fails? By repeatedly repromulgating retroactive wage index rules, the Secretary could engage respondents and the courts in endless litigation over respondents' *1981* Medicare reimbursement. Forcing respondents to continue to relitigate this matter for a cost reporting year long since past, as the Secretary creates new retroactive rules and new retroactive rulemaking records, is inconsistent with basic notions of justice and fair play and wasteful of judicial resources. *See Tallahassee,* 815 F.2d at 1454 n.38, 1455 & n.41, 1456; *Mason General,* 809 F.2d at 1225; *Albany General Hospital v. Heckler,* 657 F. Supp. 87, 92 (D. Or. 1987), *appeal docketed,* No. 87-3688.

The closest analogy to the Secretary's 1984 retroactive wage index rule is the Secretary's 1986 rule governing the apportionment of malpractice insurance costs. *See* 42 C.F.R. § 413.56. The Secretary published the 1986 rule to "cure" his

(footnote continued)

Secretary's concern is based on the false premise that but for the issuance of the 1984 retroactive wage index rule, *DCHA* would have required recoupment from hospitals that benefited from the wage index that excluded federal government hospital data. But only a small number of hospitals participated in *DCHA*. The district court instructed hospitals that sought payment under the wage index which includes federal government hospital data to file appropriate claims. Pet. App. at 63a. Hospitals which benefited from the 1981 rule obviously would not file such claims. Judge Oberdorfer made it very clear that neither his decision in *DCHA,* nor in the instant case, required recoupment from such hospitals. Pet. App. at 38a-39a.

The Secretary's suggestion that but for the issuance of his retroactive rule, he would have been required to recoup from such hospitals is disingenuous. Although, as discussed below, eight courts of appeals have invalidated the Secretary's 1979 Medicare rule governing the apportionment of malpractice insurance costs, the Secretary has never suggested that he is required to recoup from the hospitals which benefited from that rule. To the contrary, his consistent position has been that it would be unfair to recoup from such hospitals and he is not required to do so. *See* 51 Fed. Reg. 11,149, 11,184, 11,186, 11,187, 11,188 (1986).

1979 malpractice rule after literally scores of courts invalidated his 1979 malpractice rule and ordered payment under the preexisting rule.[37] To date, all nine courts which have considered the issue have refused to allow the Secretary to apply the 1986 malpractice rule retroactively. *See Mason General Hospital; Tallahassee Memorial Regional Medical Center; St. Peter's Medical Center v. Heckler,* 813 F.2d 398 (3d Cir. 1987); *Albany General Hospital; Miami General Hospital v. Bowen,* 652 F. Supp. 812 (S.D. Fla. 1986); *West Anaheim Community Hospital v. Bowen,* CCH Medicare and Medicaid Guide ¶ 36,609 (C.D. Cal. July 13, 1987); *St. Joseph's Hospital v. Bowen,* CCH Medicare and Medicaid Guide ¶ 36,437 (D. Ariz. Apr. 15, 1987); *Bethesda Community Hospital v. Heckler,* CCH Medicare and Medicaid Guide ¶ 36,654 (S.D.N.Y. Aug. 5, 1987); *Children's Hospital of San Francisco v. Bowen,* CCH Medicare and Medicaid Guide ¶ 36,679 (E.D. Cal. Sep. 3, 1987).

The case against the Secretary is even stronger here.[38] Unlike the 1986 malpractice rule, the 1984 retroactive wage index rule is a *cost limit* rule and thus is subject to the express

[37] The appellate court decisions reaching this result are listed in *Mason General Hospital,* 809 F.2d at 1223 n.2. As noted there, this Court denied the Secretary's petitions for *certiorari* in all three cases in which they were filed.

[38] The instant case, and the litigation involving the Secretary's 1986 retroactive malpractice rule, are part of a much broader pattern of conduct for which the Secretary has earned a well-deserved reputation for "hardball" litigation tactics, if not for outright abuse of the judicial system. HHS is the only federal agency that has actively pursued a policy of intra-circuit nonacquiescence. *See, e.g., Murray v. Heckler,* 722 F.2d 499, 503 (9th Cir. 1983); *Hillhouse v. Harris,* 715 F.2d 428, 430 (8th Cir. 1983); *Valdez v. Schweiker,* 575 F. Supp. 1203, 1206 (D. Colo. 1983). In a prime example, the Secretary continued to litigate the validity of his Medicare labor/delivery room day apportionment policy in the D.C. Circuit even though the court of appeals had twice invalidated that policy. *See Stormont-Vail Regional Medical Center v. Bowen,* 645 F. Supp. 1182, 1186-1190 (D.D.C. 1986). Indeed, he even continued to litigate the issue against the same hospitals that had prevailed in the earlier suits. *Id.* at 1191-1192. In the past two years, this Court has on three separate occasions unanimously rejected extreme positions adopted by the Secretary on jurisdictional matters. *Bethesda Hospital Association v. Bowen,* 108 S.Ct. 1255 (1988); *Bowen v. City of New York,* 476 U.S. 467 (1986); *Bowen v. Michigan Academy of Family Physicians,* 476 U.S. 667 (1986).

prospectivity requirement established by section 223(b). Moreover, here the Secretary has applied his retroactive rule to recoup from the respondents monies that he previously paid them as a result of a final court judgment, something he has not done in the case of the 1986 retroactive malpractice rule and indeed has even strongly implied would be unlawful for him to do. *See* 51 Fed. Reg. 11,149 (col. 3), 11,186 (cols. 2 and 3), and 11,187 (col. 2) (1986) ("Adoption of this final rule is not unlawful since all final, non-appealable judgments mandating . . . reimbursement [under the rule in effect before 1979] will be complied with fully.").

3. The Secretary argues that this case does not involve the "prejudice and unfair surprise" which normally make retroactivity objectionable. Brief at 19-20. He asserts that the invalid 1981 wage index rule furnished respondents with "ample notice" of the standard that the Secretary would apply to them and that respondents were not entitled to rely on any other standard. *Id.* at 39.

Contrary to the Secretary's assertion, the original 1981 rule did not furnish the respondents with "ample notice." The rule was published without any advance notice on June 30, 1981, to become effective the next day, thereby violating not only the APA's notice and comment requirements, but also the APA's thirty day delayed effective date requirement (5 U.S.C. § 553(d)). Like other business entities, hospitals operate under established labor and supply contracts that generally cannot be terminated at will. Significantly, the Secretary had recognized in the past that "accommodation to a lower cost level may require adjustment of staff schedules and purchasing practices that is hard to accomplish quickly" and had allowed *one or two year* grace periods to allow hospitals sufficient time to effect such adjustments before applying significant new cost limit rules. 43 Fed. Reg. 25,873 (1978), J.A. at 77; *see also* 41 Fed.

Reg. 36,992 (1976). The Secretary's assertion that the one day's prior notice furnished by the *invalid* 1981 schedule was "ample" is patently absurd.[39]

If the Secretary had promulgated the 1981 wage index rule in accordance with APA procedures, he would have had to publish the final rule by June 1, 1981, to make it effective July 1, 1981. 5 U.S.C. § 553(d) (App. at 2). And to satisfy the prior notice and comment requirements of the APA, the Secretary would have had to publish a proposed notice several months before June 1, 1981.[40] 5 U.S.C. § 553(b)-(c) (App. at 1-2). If the Secretary had followed this procedure, respondents might well have had sufficient time to take the necessary cost-cutting measures to prevent, or at least significantly mitigate, cost limit disallowances. Moreover, if the Secretary had published a valid *prior* notice, respondents might well have had a *fair* opportunity to dissuade the Secretary from adopting the proposed change or to persuade him to delay the change or grant temporary grace periods, as he had done in the past.

Nor were respondents required to rely on the Secretary's invalid rule, as the Secretary argues. Respondents were entitled instead to "rely[ ] upon [their] legal rights."[41] *Forbes Pioneer Boat Line v. Board of Commissioners,* 258 U.S. 338, 340

[39] In their comments on the Secretary's 1984 proposed retroactive rule, respondents reminded the Secretary of his prior recognition of the difficulties involved in making cost adjustments quickly and of his prior practice of granting grace periods (Rec. at 149-150), but the Secretary did not respond to respondents' comments in his final notice (J.A. at 29-47).

[40] The Secretary's 1984 final retroactive wage index rule was published on November 26, 1984, more than nine months after the proposed rule was published on February 17, 1984. Based on a review of all final Medicare regulations published by the Secretary in 1987, respondents have determined that, on the average, 409 days elapsed between publication of the proposed rule and publication of the final rule.

[41] This is particularly true because the 1981 wage index was patently invalid. The *DCHA* court found that the Secretary's invocation of the "good cause" exception "does not survive even deferential scrutiny," much less the strict scrutiny normally applied in this circumstance. Pet. App. at 58a. The Secretary essentially argued that "mere incantation" by the agency was sufficient to trigger the "good cause" exception. *Id.*

(1922). They succe[illegible]fully pursued those rights in *DCHA* and are rightfully entitled to the amounts paid to them by the Secretary as a result of that decision.

4. The Secretary relies on several early decisions of this Court which he characterizes as involving "the analogous question of the validity of curative legislation." Brief at 18-19. However, the only cited case that bears any resemblance to the facts here is *Forbes Pioneer Boat Line,* which rejected the curative legislation under review. Typical of the other cases is *Graham v. Goodcell,* 282 U.S. 409 (1931), which addressed a statute that allowed the Commissioner of Internal Revenue to collect or retain certain taxes even though, due to a misunderstanding of the law on his part, the statute of limitations for collection had previously run. In upholding the statute, this Court stressed:

> This is not a case of an attempt retroactively to create a liability in relation to a transaction as to which no liability had previously attached. There is no question here as to the original liability of the taxpayers. The tax was a valid one. . . .

282 U.S. at 426 (footnote omitted). In contrast, the instant case does involve "an attempt retroactively to create a liability in relation to a transaction as to which no liability had previously attached." The tax in *Graham* was "valid," but the 1981 wage index rule involved here was determined by a final court judgment *not* to be "valid."

Moreover, "curative" retroactive rulemaking is not "analogous to" curative legislation. It is one thing for Congress to decide to remedy an inadvertent error of its agents through curative legislation. It is quite another for an agency on its own initiative to decide to "remedy" its own culpable violation of the procedures mandated by Congress through a retroactive rule which effectively allows it to circumvent Congress' commands.

It is also clear that even "curative legislation could, if carried too far, encourage irresponsible official conduct." Slawson, *Constitutional and Legislative Considerations in Retroactive Lawmaking,* 48 Calif. L. Rev. 216, 239 (1960), *quoted in Van Emmerik v. Janklow,* 454 U.S. 1131, 1133-1134 (1982)

(White & Blackmun, JJ., dissenting from dismissal of appeal). There is absolutely no question that the curative retroactive rulemaking pursued by the Secretary here and elsewhere has had that effect and must therefore be rejected. *See Tallahassee,* 815 F.2d at 1456 ("This court cannot condone such potential abuse.").

IV. ASSUMING *ARGUENDO* THE APPLICABILITY OF A BALANCING TEST, THE ILL EFFECTS OF THE SECRETARY'S RETROACTIVE WAGE INDEX RULE FAR EXCEED ANY POSSIBLE STATUTORY INTEREST UNDERLYING THE RULE.

In *Chenery,* this Court developed a balancing test for determining the legality of retroactive adjudicative rules. The test is whether the "mischief of producing a result which is contrary to a statutory design or to legal and equitable principles . . . is greater than the ill effect of the retroactive application of a new standard. . . ." [42] 332 U.S. at 203.

For the reasons discussed in the prior sections, respondents do not believe that a balancing test is properly applicable in the context of legislative rules in general or Medicare cost limit rules in particular. However, assuming *arguendo* that a balancing test is proper, the balance clearly falls in respondents' favor.[43] As discussed in section IV.A. below, the ill effects of the Secretary's 1984 retroactive wage index rule are substantial.

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[42] The D.C. Circuit has stated that "[w]hich side of this balance preponderates is in each case a question of law, resolvable by reviewing courts with no overriding obligation of deference to the agency decision. . . ." *Retail Union,* 466 F.2d at 390. *Accord, Mason General,* 809 F.2d at 1224.

[43] Although respondents address the merits of the Secretary's 1984 retroactive wage index rule in the context of a balancing test, they also contend that the factors discussed in § IV.B. below demonstrate that the rule is arbitrary and capricious even under the standard applied to prospective rules. Respondents note that the Secretary's discussion of the arbitrary and capricious issue is marked by a curious "heads-I-win, tails-you-lose" mentality. On the one hand, the Secretary asks this Court to determine that the rule is not arbitrary and capricious. Brief at 36-40. On the other hand, he insists that for purposes of this determination, the Court must presume that the rule is substantively valid. Id. at 38 n.30. The Secretary cannot have it both ways. The Court cannot determine whether the Secretary's rule is

(footnote continues)

And as discussed in § IV.B. below, the Secretary's 1984 retroactive wage index rule has produced, not prevented, a result which is contrary both to the statutory design and to legal and equitable principles.

A. The Ill Effects Of The Secretary's Retroactive Wage Index Rule Are Substantial.

As discussed in the preceding sections, the ill effects of the Secretary's 1984 retroactive wage index rule have been substantial:

(1) The rule apparently marks the first and only time that an administrative agency has applied a retroactive rule to recoup monies previously paid by the agency as a result of a final court judgment. It also apparently marks the first and only time that an agency has by its own admission attempted to reverse a lower court judgment not through the appeals process but through retroactive rulemaking.

(2) The rule is totally devoid of "future effect." It applies solely to cost reporting years beginning in a fifteen month period that closed more than two years before the 1984 rule was even promulgated.

(footnote continued)

arbitrary and capricious without taking a hard look at the substantive validity of the rule. *See Motor Vehicle Manufacturers,* 463 U.S. at 42 ("If Congress established a presumption from which judicial review should start, that presumption . . . is . . . *against* changes in current policy that are not justified by the rulemaking record." (original emphasis)).

The Secretary's aversion to discussing the merits is particularly ironic given his repeated assertion (which he apparently asks the Court to accept on faith) that respondents received "windfalls." *See, e.g.,* Brief at 38, 40 n.33. Considering that the alleged "windfalls" resulted entirely from application of the Secretary's own preexisting rule, the Secretary's bald assertion is, to say the least, quite curious. As the absence of any supporting citations in the Secretary's brief suggests, there is not a scintilla of evidence in the record to support the Secretary's assertion. Moreover, all of the respondents were not-for-profit hospitals, and the Medicare reimbursement scheme did not provide a "profit" factor for such hospitals. Respondents received the lower of their costs or the cost limits. A hospital that at the most is reimbursed its costs can hardly be accused of receiving "windfalls." Pet. App. at 36a.

(3) The rule has the effect of rewarding the Secretary for his illegal conduct. It allows him to achieve what he could not have achieved if he had acted lawfully on June 30, 1981, when he published the 1981 schedule of limits.

The Secretary's retroactive wage index rule "dramatically departed from prior practice." Pet. App. at 35a. The Secretary had included wage data from all hospitals (including federal government hospitals) in determining the wage indexes for his prior two schedules. He had also included income from all employees (including federal employees) in determining the per capita income classifications used to measure "economic environment" in the five schedules before that. There was no intervening legislation that required, or made desirable, a change in the Secretary's methodology for measuring "economic environment." The Secretary has never explained why it suddenly became so urgent to change the methodology that for his eighth, and final, schedule of routine cost limits he resorted to the drastic and unprecedented measure at issue in this case.

B. No Statutory Interests Support Application Of The Secretary's Retroactive Wage Index Rule.

The Secretary's retroactive wage index rule does not serve any statutory interest.[44] As Judge Oberdorfer found, application of the Secretary's retroactive wage index rule contravened

[44] Respondents' ability to address the merits of the 1984 retroactive wage index rule has been hampered by the Secretary's refusal to file the complete rulemaking record. *See* plaintiff's motion to compel and supporting memoranda and exhibits, *Georgetown* Docket Nos. 9, 12, J.A. at 5. The district court ruled that "the ultimate question here may be fairly resolved without reviewing the documents and portions of documents withheld by the Secretary, so long as . . . all of the documents withheld by the Secretary are available so that in the event of an appeal, the Court of Appeals may, *if necessary,* consider whether the record before this Court satisfies the 'completeness' requirements of the APA. . . ." Memorandum dated Sept. 23, 1985, slip op. at 3 (original emphasis), *Georgetown* Docket No. 14, J.A. at 6. A week later the Secretary filed with the court two volumes of withheld materials under seal. *Georgetown* Docket No. 29, J.A. at 6. Because of its resolution of this case, the court of appeals did not find review of these materials necessary, but if this Court decides to apply a balancing test, it may wish to review the materials. The contents are, of course, known to the Secretary, but not to respondents.

Medicare statutory interests by underreimbursing respondents' costs. Pet. App. at 36a. Moreover, the rule is arbitrary and capricious because the Secretary failed to take into account many relevant factors and drew conclusions clearly contrary to the evidence before him. *See Motor Vehicle Manufacturers,* 463 U.S. at 43.

1. In the 1984 proposed notice, the Secretary provided the following explanation for his decision to exclude federal government hospital data:

> As a result of prior schedules that were issued, we received correspondence concerning the inequity of including Federal hospital wages in developing the wage index. We examined this issue and found that including Federal hospital wages resulted in wage index values that were unrealistically low in areas without Federal hospitals in comparison to adjacent areas with Federal hospitals. . . . Yet these adjacent areas with an unrealistically low wage index were competing for the same employees as those areas whose only difference in average wages was the fact that a Federal hospital was located in the SMSA. . . . Including Federal hospital wage data resulted in wage indexes that did not reflect the differences in wages from area to area. Therefore, in order to correct this inaccuracy, we excluded Federal hospital data from the 1981 wage index.

49 Fed. Reg. 6,177 (col. 1) (1984), J.A. at 20-21. The evidence in the record clearly contradicts this explanation.

The "correspondence" referred to by the Secretary is apparently a letter dated December 12, 1980, from the Memorial Hospitals Association, which represents hospitals in the Modesto, California SMSA. Rec. at 504-506. The Association complained about the disparity in the Secretary's wage indexes for three contiguous SMSAs—Modesto, Fresno, and Stockton. *Id.* at 504. The Association alleged a "close parity" in actual hospital wages for the three SMSAs and attributed the disparity in the Secretary's wage indexes for the three SMSAs to the inclusion of government hospital data. *Id.* at 504-505. The

Association requested *not* the exclusion of government hospital data, but the consolidation of the three SMSAs into a single economic unit. *Id.* at 505.

Instead of adopting the Association's suggestion, the Secretary elected to exclude federal government hospital data in determining the wage indexes. The evidence clearly shows, however, that this did virtually nothing to eliminate the disparity in the Secretary's wage indexes for the three SMSAs. The wage indexes in the 1980 schedule, which were based on 1978 BLS data that *included* federal government hospital data, were as follows:

Modesto— .9527
Fresno— 1.1454
Stockton— 1.2994.

Rec. at 489. The wage indexes in the 1981 schedule, which were based on 1979 BLS data that *excluded* federal government hospital data, were as follows:

Modesto— 1.0250
Fresno— 1.1266
Stockton— 1.3047.

Id. The effect of the exclusion was to decrease somewhat the differential between Stockton and Modesto (from 36.4% to 27.3%) but to increase somewhat the differential between Stockton and Fresno (from 13.4% to 15.8%).

An internal agency report acknowledged that "removal of Federal hospitals from the data base did not substantially improve Modesto's position." *Id.* at 486. Thus, if the three SMSAs truly had comparable hospital wages (as the evidence suggests (Rec. at 497-500)), the exclusion of federal government hospital data obviously was not the solution to the problem. The agency's internal report concluded that some other factors in the BLS data or the Secretary's methodology accounted for the distortion in the relative values of the Secretary's wage indexes for the three SMSAs. *See* Rec. at 488. The agency nonetheless proceeded to exclude federal government hospital data *for all SMSAs* even though it knew that this did not resolve the identified problem even for the three SMSAs it had studied.

Respondents have accurately summarized the *only evidence in the record* regarding the effect of federal government hospital data on the wage indexes of adjacent SMSAs. Accordingly, the record reveals that "the agency has . . . offered an explanation for its decision that runs counter to the evidence before the agency. . . ." *Motor Vehicle Manufacturers,* 463 U.S. at 43.

2. According to the Secretary, the purpose of his wage index was to reflect "area variations in wage levels." 49 Fed. Reg. 6,176 (col. 2) (1984), J.A. at 19. He attempted to justify the exclusion of federal government hospital data from his wage index formula on the ground that "the wages paid by a Federal hospital do not reflect the local economy since Federal wages are based primarily on national pay scales." 49 Fed. Reg. 46,497 (col. 1) (1984), J.A. at 34. He conceded, however, that this was only a "belief" (49 Fed. Reg. 46,497 (col. 3) (1984), J.A. at 37) and a "theory" (49 Fed. Reg. 46,498 (col. 2) (1984), J.A. at 39). He produced no evidence to support his "belief" or "theory" that all federal hospitals pay according to the same pay scale.

In their public comments, respondents reminded the Secretary of certain evidence from the *DCHA* case. Rec. at 150-151. During that litigation, respondents had asked BLS to calculate the average monthly wage for federal hospitals in the Washington, D.C.-Maryland-Virginia SMSA and for four other SMSAs *chosen at random by BLS. Id.* The results were as follows:

SMSAs	Average Monthly Wages
San Francisco-Oakland, CA	$1,564.75
New York, NY-NJ.....	1,485.49
Washington, D.C.-MD-VA	1,323.47
San Antonio, TX	1,268.30
Norfolk-Virginia Beach-Portsmouth, VA-NC	1,175.48

Id. at 151.

The data provided for these five SMSAs suggested that federal hospital wages roughly reflected regional wage and cost of living differences: the New York and San Francisco SMSAs, which might be expected to have relatively high wage rates and costs of living, were also associated with high federal hospital average monthly wages. And the San Antonio and Norfolk-Virginia Beach-Portsmouth SMSAs, which might be expected to have relatively low wage rates and costs of living, were associated with significantly lower federal hospital average monthly wages. As might be expected, federal hospital average monthly wages for the Washington, D.C. SMSA fell between these extremes.

The differences reflected in the BLS data for these five SMSAs were not minimal. Indeed, the federal hospital average monthly wage in the San Francisco-Oakland SMSA was 33% higher than in the Norfolk-Virginia Beach-Portsmouth SMSA. It is hard to believe that this could happen if, as the Secretary "believed," the hospitals in the two SMSAs paid according to the same scale. Based in part upon this evidence, the *DCHA* court stated that "plaintiffs have demonstrated that the Secretary may have been unaware or even mistaken about some facts central to the decision" and concluded that the Secretary "may have . . . erred in [his] assumption that federal government hospitals 'typically' set their wages according to 'national pay scales.' " Pet. App. at 59a & n.8.

The Secretary's response to respondents' comments regarding the evidence in *DCHA* is clearly unsatisfactory. He stated that his wage index is riddled with numerous "technical deficiencies," any of which "could account for the discrepancy in average monthly wages" noted by respondents. 49 Fed. Reg. 46,498 (col. 1) (1984), J.A. at 39. His explanation is unconvincing, however, given that the federal hospitals with the higher wages were the ones located in the SMSAs with the higher costs of living. Moreover, if the Secretary's explanation were correct, any attempt to improve the accuracy of the wage index through a single change appears pointless. If the "technical deficiencies" in the Secretary's data were so serious that they produced a 33% difference in the average monthly

wage figures of hospitals which, in fact, had the same wages (as the Secretary suggested), then the only rational conclusion is that the wage index data was hopelessly flawed.

Agency reliance on a faulty study is arbitrary and capricious. *Walter O. Boswell Memorial Hospital v. Heckler,* 749 F.2d at 803; *Almay, Inc. v. Califano,* 569 F.2d 674, 682 (D.C. Cir. 1977). Here, the Secretary failed to do any study whatsoever. Instead he continued to rely on the same unexamined "assumption" used in the original 1981 schedule, even though the *DCHA* court had already concluded that that "assumption" may have been erroneous and the public comments specifically reminded the Secretary of this fact (Rec. at 151).

The Secretary's failure to do his homework is also reflected in his erroneous assertion that only a "few hospitals" are "located in an area with Federal hospital employees." 49 Fed. Reg. 6,178 (col. 2) (1984), J.A. at 26; 49 Fed. Reg. 46,499 (col. 3) (1984), J.A. at 45. During 1980, there were, in fact, 359 federal government hospitals, and they accounted for more than 10% of total hospital wages ($4,927 million of $46,972 million). *See* American Hospital Association, *AHA Guide to the Health Care Field* A8 (Table 1) (1981). Analysis of an exhibit filed by the Secretary in *DCHA* reveals that at least one federal government hospital was located in 46.6% of all SMSAs. *See DCHA* Docket No. 17, Notice of Filing by Defendant, dated Jan. 26, 1983 (Defendant's Exhibit 8).[45]

In *DCHA,* the court criticized the Secretary for failing to properly consider the extent of the presence of federal government hospitals. Pet. App. at 59a & n.8. The Secretary nonetheless continued to ignore this "relevant factor" in promulgating the 1984 retroactive wage index rule.

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[45] The Secretary's Exhibit 8 consists of two tables, one furnishing data by SMSA based on the inclusion of federal government hospitals and the other furnishing data by SMSA based on the exclusion of federal government hospitals. The "total wages" column in the table which includes federal government hospitals is greater than in the table which excludes such hospitals for 116 of the 249 SMSAs listed, reflecting the presence of federal government hospitals in those SMSAs. (The "total wages" column in the two tables is identical for the other 133 SMSAs, thus obviously reflecting an absence of federal government hospitals in those SMSAs.)

3. Throughout the preamble to the final rule, the Secretary asserted that if federal wages affected the local labor market, then the wage index for an SMSA would not be significantly affected by the exclusion of federal hospital data because the wages of federal and non-federal hospitals would be comparable. He noted that for the five SMSAs cited in respondents' comments (discussed above), the average monthly wage for the federal hospitals was higher than for the non-federal hospitals and concluded that this proved his "*theory* that Federal hospitals are not paying local wages." 49 Fed. Reg. 46,498 (col. 2) (1984) (emphasis added), J.A. at 39. He stated that "[i]f the Federal hospitals were paying local wages, the average monthly wage for Federal hospitals would be the same figure as the average monthly wage not including Federal hospitals for the same SMSA." *Id.*

The Secretary's conclusion was based on the premise that an SMSA is a single labor market, but the record proves that premise to be false. Rec. at 96-141 and 152-153. Most SMSAs consist of an urban "core" and a large suburban "ring." For instance, the District of Columbia SMSA includes Calvert, Charles, Frederick, Montgomery and Prince George's Counties in Maryland, and Alexandria, Fairfax, Falls Church, Manassas, and Manassas Park Cities, and Arlington, Fairfax, Loudoun, Prince William, and Stafford Counties in Virginia.[46] Rec. at 128; *see also* 48 Fed. Reg. 39,874 (1983). Labor costs are much lower in Loudoun, Prince William, and Stafford Counties (all of which are largely rural) than in the District of Columbia. Rec. at 128. Indeed, according to information furnished by BLS for 1981, if the computations for the District of Columbia and the surrounding suburbs were made separately, the wage index (excluding federal hospital data) would be 1.3286 for the District of Columbia and 1.0281 for the Washington suburbs, a difference of .3005 (or 29%). Id. at 124.

[46] The SMSA boundaries extend all the way to West Virginia to the West, Pennsylvania to the North, the Chesapeake Bay to the East, and more than halfway to Richmond to the South.

Nor is the District of Columbia SMSA unusual in this regard, as the following results (taken from a sample of four other SMSAs from which federal hospital data was excluded) reflect:

City	Core Jurisdiction	Surrounding Suburban Jurisdictions	Core to Suburban Relationship
Chicago	1.2347	.9547	+29%
Cleveland	1.2182	.9801	+24%
Minneapolis/St. Paul	1.0344	.9884	+ 5%
Philadelphia/Camden	1.2456	1.0807	+15%

Rec. at 124.

Thus, the fact that the Secretary found, in five SMSAs, that the average monthly wage of the federal hospitals was higher than the average monthly wage of the non-federal hospitals does not prove, as the Secretary assumed, that federal hospitals do not affect the local labor market. If the Secretary had checked, he unquestionably would have found that the average monthly wage of non-federal hospitals in the urban "core" of these SMSAs is higher than the average monthly wage of all the non-federal hospitals (core and ring) in the SMSAs. What the Secretary's finding almost certainly reflects is not that federal hospitals are isolated from local conditions but that, as is clearly the case in the District of Columbia SMSA, most federal hospital employees work in the urban "core," which is a different labor market (with significantly higher wages) than the suburban "ring."

As a practical matter, the Secretary's assumption that wages at federal hospitals do not affect the local economy is contrary to common sense. Non-federal hospitals will not want to lose their best employees to federal hospitals. Consequently, as a matter of simple economic reality, they have little choice but to offer wages competitive with the federal hospitals in their market.

4. The Secretary asserted that the exclusion of federal hospital data produced a more accurate wage index. 49 Fed.

Reg. 6,177 (col. 1) (1984), J.A. at 21. The evidence in the record proves otherwise.

The District of Columbia SMSA is a case in point. According to *1981* BLS data, a separate calculation for non-federal District of Columbia hospitals *only (i.e.,* non-federal urban "core" hospitals only) would yield a wage index of 1.3286. Rec. at 124. Yet, as a result of the inclusion of wage data from hospitals in the suburban "ring" of the SMSA, the Secretary's retroactive wage index rule imposed a 1.1547 wage index on District of Columbia hospitals. 49 Fed. Reg. 46,501 (col. 1) (1984). The wage index which included federal hospital data (which the Secretary originally used to pay the District of Columbia respondents) was 1.1953. While that index was far less than hospitals in the District of Columbia should have received (according to the BLS data), it was nonetheless considerably closer to the correct figure (1.3286) than the wage index which the Secretary retroactively imposed (1.1547).[47] Thus, the inclusion of federal hospital data improved the accuracy of the Secretary's wage index because it mitigated the unfairness of the Secretary's failure to differentiate between the urban "core" and the suburban "ring" within an SMSA.

The elimination of federal hospital data—unaccompanied by any differentiation between the urban "core" and the suburban "ring"—was arbitrary and capricious. The effect for urban "core" hospitals was to eliminate from the wage pool the wage data from the federal hospitals with which they competed but to retain in the pool the wage data from distant suburban hospitals with which they did not compete.[48]

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[47] Although the reduction in the wage index hurt hospitals in the urban core, it did not hurt the suburban hospitals. Because of the lower wages in the suburbs, suburban hospitals should have been well below the limit, whichever wage index was used to compute the limit. The wage index was used to compute a "limit," not a "rate."

[48] During 1981, the District of Columbia had three federal hospitals, all of which were large—Walter Reed Army Medical Center (5,060 employees), St. Elizabeth's Hospital (4,068 employees), and Veterans Administration

(footnote continues)

The perverse results produced by the Secretary's methodology are also well-illustrated by the St. Cloud SMSA. Six hospitals were located in the St. Cloud SMSA. Rec. at 75. Two were large hospitals located in the City of St. Cloud (population 42,566)—St. Cloud Hospital with 522 hospital beds and a federal government hospital with 818 hospital beds.[49] *Id.* The remaining four were small hospitals (bed sizes ranging from 26 to 46) located in small towns (populations ranging from 1,569 to 3,709) many miles away from the City of St. Cloud. *Id.* Under the Secretary's methodology, the wage index for the St. Cloud SMSA was established by averaging the wages of St. Cloud Hospital with the lower wages of the four small, distant hospitals with which it did not compete for employees, but by excluding from the pool the higher wages of the large, nearby federal government hospital with which it did compete for employees. *Id.* at 82. Thus, under the Secretary's methodology, it was virtually inevitable that St. Cloud Hospital's costs would be above the cost limits, no matter how efficiently it operated. The Secretary's methodology not only mixed apples with oranges, but did not even include all the apples in the mix. *See Georgetown,* Pet. App. at 37a (noting that the Secretary had "failed to confront with sufficient particularity . . . the effect of area differentials and *relevant* labor markets on average hospital wage levels." (original emphasis)).

5. In the preamble to the retroactive wage index rule, the Secretary addressed whether he should establish separate wage indexes for the urban "core" and the suburban "ring" within an SMSA. 49 Fed. Reg. 46,498 (col. 2) (1984), J.A. at 40. He acknowledged that "in principle" this "could provide a more

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(footnote continued)

Medical Center (1,698 employees). *See* American Hospital Association, *AHA Guide to the Health Care Field* A50 (1981). Both Walter Reed and St. Elizabeth's had far more employees than any non-federal hospital in the District. Of the fourteen non-federal hospitals in the District, six had fewer than 1,000 employees, five had more than 1,000 but fewer than 2,000, and three had more than 2,000 but fewer than 3,000. Id. Because of their size, the three federal hospitals accounted for 37.5% (10,826 divided by 28,904) of all hospital employees in the District. *Id.*

[49] Convalescent and nursing care ("C&NC") beds and bassinets have been excluded from the bed totals.

precise wage index." *Id.* However, he noted that the BLS data contains numerous "technical deficiencies" and concluded, *with no explanation,* that "disaggregating the data into 'core-ring' indexes would only magnify the inherent limitations of the BLS data and increase the potential for distortion. . . ." *Id.*

This same rationale for inaction should have been equally applicable to the Secretary's proposal to exclude federal government hospital data. If "disaggregating" the BLS data into "core-ring" indexes "would only magnify the inherent limitations of the BLS data and increase the potential for distortion," then why would "disaggregating" the BLS data to exclude federal hospital data not have the same effect? The Secretary provided no explanation for his position, which is obviously internally inconsistent.

CONCLUSION

For the foregoing reasons, the Court should affirm the judgment below.

Respectfully submitted,

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APPENDIX

STATUTES AND REGULATIONS INVOLVED

1. **5 U.S.C. § 551(4)—**

For the purpose of this subchapter—

* * * * *

(4) "rule" means the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services or allowances therefor or of valuations, costs, or accounting, or practices bearing on any of the foregoing.

2. **5 U.S.C. § 553(b)-(d)—**

(b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include—

(1) a statement of the time, place, and nature of public rule making proceedings;

(2) reference to the legal authority under which the rule is proposed; and

(3) either the terms of substance of the proposed rule or a description of the subjects and issues involved.

* * * * *

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral

presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. . . .

(d) the required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except—

(1) a substantive rule which grants or recognizes an exemption or relieves a restriction;

(2) interpretive rules and statements of policy; or

(3) as otherwise provided by the agency for good cause found and published with the rule.

3. 5 U.S.C. § 706—

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall—

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions found to be—

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; [or]

(D) without observance of procedure required by law;

* * * * *

4. 42 U.S.C. § 1395x(v)(1)(A) (Section 1861(v)(1)(A) of the Social Security Act)—

The reasonable cost of any services shall be the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services, and shall be determined in accordance with regulations establishing the method or methods to be used, and the items to be included, in determining such costs for various types or classes of institutions, agencies, and services. . . . In prescribing the regulations referred to in the preceding sentence, the Secretary shall consider, among other things, the principles generally applied by national organizations or established prepayment organizations (which have developed such principles) in computing the amount of payment, to be made by persons other than the recipients of services, to providers of services on account of services furnished to such recipients by such providers. Such regulations may provide for determination of the costs of services on a per diem, per unit, per capita, or other basis, may provide for using different methods in different circumstances, may provide for the use of estimates of costs of particular items or services, may provide for the establishment of limits on the direct or indirect overall incurred costs or incurred costs of specific items or services or groups of items or services to be recognized as reasonable based on estimates of the costs necessary in the efficient delivery of needed health services to individuals covered by the insurance programs established under this subchapter, and may provide for the use of charges or a percentage of charges where this method reasonably reflects the costs. Such regulations shall (i) take into account both direct and indirect costs of providers of services (excluding therefrom any such costs, including standby costs, which are determined in accordance with regulations to be unnecessary in the efficient delivery of

services covered by the insurance programs established under this subchapter) in order that, under the methods of determining costs, the necessary costs of efficiently delivering covered services to individuals covered by the insurance programs established by this subchapter will not be borne by individuals not so covered, and the costs with respect to individuals not so covered will not be borne by such insurance programs, and (ii) provide for the making of suitable retroactive corrective adjustments where, for a provider of services for any fiscal period, the aggregate reimbursement produced by the methods of determining costs proves to be either inadequate or excessive.

5. Pub. L. No. 92-603, § 223(b) (1972)—

The third sentence of section 1861(v)(1) of [the Social Security] Act is amended by striking out the comma after "services," where it last appears and inserting in lieu thereof the following: "may provide for the establishment of limits on the direct or indirect overall incurred costs or incurred costs of specific items or services or groups of items or services to be recognized as reasonable based on estimates of the costs necessary in the efficient delivery of needed health services to individuals covered by the insurance programs established under this title,".

6. 42 C.F.R. § 413.9(b)(1)—

(b) *Definitions*—(1) *Reasonable cost.* Reasonable cost of any services must be determined in accordance with regulations establishing the method or methods to be used, and the items to be included. The regulations in this part take into account both direct and indirect costs of providers of services. The objective is that under the methods of determining costs, the costs with respect to individuals covered by the program will not be borne by individuals not so covered, and the costs with respect to individuals not so covered will not be borne by the program. These regulations also provide for the making of suitable retroactive adjustments after the provider has submitted fiscal

and statistical reports. The retroactive adjustment will represent the difference between the amount received by the provider during the year for covered services from both Medicare and the beneficiaries and the amount determined in accordance with an accepted method of cost apportionment to be the actual cost of services furnished to beneficiaries during the year.

7. 42 C.F.R. § 413.30(a), (b)(3)—

(a) *Introduction*—(1) *Scope.* This section implements section 1861(v)(1)(A) of the Act, by setting forth the general rules under which HCFA may establish limits on provider costs recognized as reasonable in determining Medicare program payments. . . .

* * * * *

(2) *General principle.* Reimbursable provider costs may not exceed the costs estimated by HCFA to be necessary for the efficient delivery of needed health services. HCFA may establish estimated cost limits for direct or indirect overall costs or for costs of specific items or services or groups of items or services. These limits will be imposed prospectively and may be calculated on a per admission, per discharge, per diem, per visit, or other basis.

(b) *Procedure for establishing limits.*

* * * * *

(3) Prior to the beginning of a cost period to which revised limits will be applied, HCFA will publish a notice in the *Federal Register,* establishing cost limits and explaining the basis on which they were calculated.

8. 42 C.F.R. § 413.64(a)(1), (b), (f)—

(a) *Principle*—(1) *Reimbursement on a reasonable cost basis.* Providers of services paid on the basis of the reasonable cost of services furnished to beneficiaries will

receive interim payments approximating the actual costs of the provider. These payments will be made on the most expeditious schedule administratively feasible but not less often than monthly. A retroactive adjustment based on actual costs will be made at the end of a reporting period.

* * * * *

(b) *Amount and frequency of payment.* Medicare states that providers of services will be paid the reasonable cost of services furnished to beneficiaries. Since actual costs of services cannot be determined until the end of the accounting period, the providers must be paid on an estimated cost basis during the year. While Medicare provides that interim payments will be made no less often than monthly, intermediaries are expected to make payments on the most expeditious basis administratively feasible. Whatever estimated cost basis is used for determining interim payments during the year, the intent is that the interim payments shall approximate actual costs as nearly as is practicable so that the retroactive adjustment based on actual costs will be as small as possible.

* * * * *

(f) *Retroactive adjustment.* (1) Medicare provides that providers of services will be paid amounts determined to be due, but not less often than monthly, with necessary adjustments due to previously made overpayments or underpayments. Interim payments are made on the basis of estimated costs. Actual costs reimbursable to a provider cannot be determined until the cost reports are filed and costs are verified. Therefore, a retroactive adjustment will be made at the end of the reporting period to bring the interim payments made to the provider during the period into agreement with the reimbursable amount payable to the provider for the services furnished to program beneficiaries during that period.

(2) In order to reimburse the provider as quickly as possible, an initial retroactive adjustment will be made as soon as the cost report is received. For this purpose, the costs will be accepted as reported, unless there are obvious

errors or inconsistencies, subject to later audit. When an audit is made and the final liability of the program is determined, a final adjustment will be made.

(3) To determine the retroactive adjustment, the amount of the provider's total allowable cost apportioned to the program for the reporting year is computed. This is the total amount of reimbursement the provider is due to receive from the program and the beneficiaries for covered services furnished during the reporting period. The total of the interim payments made by the program in the reporting year and the deductibles and coinsurance amounts receivable from beneficiaries is computed. The difference between the reimbursement due and the payments made is the amount of the retroactive adjustment.